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4 May 2020

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

By email: MDAG@ea.govt.nz

Dear Tony,

Re: High standard of trading conduct provisions – Discussion paper

Genesis Energy appreciates the opportunity to respond to the *High standard of trading conduct provisions – Discussion paper* and the consultative approach taken to date.

Genesis agrees 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. Certainly, MDAG's proposal is superior to the alternatives set out in Part D of the MDAG discussion paper, which often represent risky, costly, and disproportionate interventions.

Broadly, Genesis agrees with 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. However, we differ on how that concept is best implemented.

In summary, Genesis contends:

(a) the electricity generation market is generally workably competitive but there are occasions where generators have the ability to exercise unfettered market power - that is, when they are pivotal in the market;

(b) the discussion paper correctly identifies the problem to be addressed – that generators should not be able to exercise market power when making offers;

(c) therefore, the solution must be focussed on clarifying the standard that a generator must meet in submitting offers when it is pivotal and it should not be a blanket standard that applies to all offer conduct;

(d) however, in our view, the proposed solution is not appropriately targeted at the problem and follows a legal and economic approach that has been developed for monopolies and is not applicable to workably competitive markets;

(e) 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.

This position is set out in our full submission below, including a proposed alternative approach provided for MDAG and the Authority's consideration.

Process and approach

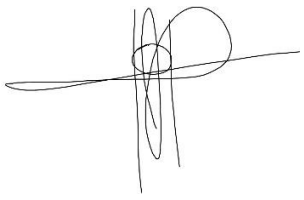
We welcome the opportunity to input and engage constructively having recently experienced first-hand the consequences of ambiguous regulation with our EA investigation into islanded generation at Tekapo A. Given our experience with application of the existing regulation in this space, we strongly support taking the opportunity to ensure any ambiguity is addressed and adequate certainly is provided for the benefit of all concerned. We have concerns about any suggestion that this proposal could proceed to a Code change without the usual consultation process as we consider this heightens the risk of a less than optimum outcome.

For the reasons set out below, Genesis feels the proposal as drafted could impose significant costs on participants in addition to those necessary to achieve its aim. It should therefore be subject to the usual scrutiny that major Code changes receive.

Genesis believes the full Code change process would provide the opportunity for the costs and benefits to be fully understood, and for the parallel development of guidance on the application of the new rules. This would improve the likelihood of the proposal being appropriately targeted and proportionate and, therefore, effective and enduring.

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

Yours sincerely



Matt Ritchie
Senior Advisor, Regulatory Affairs and Government Relations

Genesis Energy submission: *High standard of trading conduct provisions – Discussion paper*

Problem to be addressed

1. Genesis agrees with the Market Development Advisory Group's ("**MDAG**") definition of the problem, which is to prevent participants from taking advantage of unfettered market power - that is, when they are pivotal.

2. The electricity generation market is generally workably competitive, but there are occasions where generators have the ability to exercise market power. The intent of the original High Standard of Trading Conduct provision ("**HSOTC**") was to encourage consistent offer conduct across trading periods that were competitive or otherwise.[1] This should remain the objective. 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[2]. The problem to address is when pivotal generators are able to submit offers that take advantage of (transient) market power.

3. As further explained below, Genesis therefore submits that the solution must be focussed on clarifying the standard that a generator must meet in submitting offers when it is pivotal – and it should not be a blanket standard that applies to all offer conduct.

A price control standard is inappropriate

4. Genesis agrees with MDAG's position that:

   (a) The wholesale electricity market is designed so that effective rivalry among market participants delivers economic efficiency outcomes for the long-term benefit of consumers.[3]

   (b) In pivotal situations offers are justified if they are consistent with offers that would have occurred if the market in the relevant trading periods had been competitive.[4]

5. We note that the electricity market is uncapped, and that MDAG has recognised that price caps should not be considered unless other improvements have been exhausted or ruled out.[5]

6. We therefore do not understand why MDAG has proposed an approach that will effectively impose a price control type standard on all offers made in the market. This materially undermines the function of the competitive market, which has historically enabled new entry, enforced divestment and promotion of futures

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[1] Market Development Advisory Group, "High Standard of Trading Conduct provisions: A Review by the Market Development Advisory Group – Discussion Paper", 25 February 2020 ("**Discussion Paper**"), at [viii].
[2] Discussion paper, at 90.
[3] Discussion Paper, at [xiv].
[4] Discussion Paper, at 43.
[5] Discussion Paper, at 41.

trading to improve competition – i.e. the types of structure and incentive remedies favoured by Professor Littlechild, as cited in the paper.[6]

7. In particular, although expressed as a purpose statement, proposed subclause (3) will inevitably be interpreted as a requirement that offers not exceed (for too much or too long) the associated "economic costs" of generation – assuming a market in which no generator has market power. A standard that allows the regulator to determine an allowable offer price based on its assessment of associated economic costs effectively imports a price control type standard on a competitive market.

8. We consider it unlikely that any previous Wholesale Advisory Group (**"WAG"**) or MDAG discussions, nor any of the economic papers cited by MDAG recommend such an approach. Professor Littlechild certainly does not. As acknowledged in the paper, Professor Littlechild points out the pitfalls of using prices above marginal cost as an indicator of market power: [7]

> it would be commercial suicide for a generator to assume that the market will always be in equilibrium and that it should price at marginal cost.

9. Similarly, the discussion of workably competitive markets in the *Wellington Airport* case must be considered in its proper context. It does not provide a sound (if any) basis to inform the regulation of offer conduct in the wholesale electricity market. Part 4 of the Commerce Act regulates monopolies, and requires the regulator to promote outcomes consistent with outcomes in workably competitive markets. The High Court was therefore grappling with the task of assessing whether the applicable regulatory rules, as applied to monopolies, would generate outcomes consistent with workably competitive markets.

10. The Court arrived at the relatively simple proposition that if rules were set so that monopolies could only set prices to recover efficient costs (including a normal return), then this would produce outcomes consistent with workably competitive markets. However as demonstrated by the multiple years of Commerce Commission consultation, and the 1,000-page High Court judgement, ascertaining "efficient costs" that would be produced in a workably competitive market is a tremendously complex exercise.

11. As the proposal is currently formulated, we do not see that ascertaining "economic costs" in a workably competitive market would be any easier than the task under Part 4. This is the key point made by Professor Littlechild - that price or cost is not a reliable measure of market power in wholesale electricity generation markets. This is particularly true given that trading on the wholesale spot market is only one part of wholesale trading – i.e. hedging is an important determinant of overall costs recovered by generators.

12. In summary, Genesis considers that the wholesale electricity market has been established with the type of structures and incentives envisaged by Professor Littlechild to protect against the exercise of market power. It can be relied on, most of the time, to discover and produce offers that allow for recovery of efficient costs.

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[6] Discussion Paper, at [107].
[7] Professor Stephen Littlechild, "Electricity: Regulatory Developments Around the World", The Beesley Lectures, 12 November 2001, at 10.

All that is required now is to translate those outcomes into the transient periods where the market is not workably competitive. Clearly, the market does not now need a Part 4 imitation exercise that seeks to ascertain an estimate (which will be complex and contentious) of efficient or economic costs that a (strongly) competitive market would allow a generator to recover.

13. It is not surprising that we have not been able to identify any instances of conduct being linked to costs in electricity markets in other jurisdictions and that, in response to a question in its stakeholder presentation, MDAG confirmed that the proposal was not modelled against or drawn from conduct rules in a specific jurisdiction. Given the unusual nature of implementing an obligation that links offer conduct to economic cost in a workably competitive market, we would not expect to see this applying in any jurisdiction, and do not support its application in New Zealand.

The workable competition standard

14. 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 therefore will be open to legal challenge if it is included in the Code.[8] In particular, 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.[9] MDAG expressly rejects a workable competition objective.

15. In the *Wellington Airport* case, the High Court acknowledged that there was no such thing as perfect competition, and that strong competition was not possible to achieve at all times.[10] The Court therefore noted that "workable competition" was a more appropriate standard to seek to replicate in economic regulation (as has long been established under the Commerce Act).

16. 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.[11] Periods of limited competition are a feature of a competitive market, which is exactly the problem that the HSOTC provisions seek to address. However, instead of preventing the use of market power, MDAG's proposal appears to be seeking (impossibly) to replicate perfect or strong competition, in all trading periods.

17. It is very clear from the *Wellington Airport* case, other case law on the Commerce Act, and the Electricity Authority's interpretation of its objectives under the Electricity Industry Act, that "workable competition" is the correct standard across various competition and regulatory contexts. It is equally clear that workably competitive markets deliver efficient outcomes for the long-term benefit of consumers over time – whether efficient outcomes are being delivered cannot be measured by a "snapshot" comparison of prices and costs. For example:

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[8] Electricity Industry Act 2010, s 32(1)(a).
[9] Discussion Paper, at [xvii].
[10] *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289, at [11]
[11] Discussion Paper, at 49.

(a) The High Court explained that in workably competitive markets prices frequently depart from efficient costs, and may never equal them. Key is whether prices trend towards efficient costs over time;[12]

(b) The Electricity Authority has previously noted that workable competition is a dynamic, and not static, efficiency concept. Dynamic efficiency is achieved if prices tend towards an efficient equilibrium over time.[13]

18. In summary, it is well understood that comparing prices to costs in any given period (especially if it is a short period) is an unreliable indicator of whether market power has been exercised and/or whether efficient outcomes are being delivered for the long term benefit of consumers. Consideration of all relevant circumstances is required.

19. MDAG's concerns about using "workably competitive" markets as a counterfactual should fall away if the counterfactual is based on actual conduct that occurs in conditions where a generator was not pivotal – i.e. where generators are unable to exercise unfettered market power. As we discuss below, we believe it is possible to design a solution that is:

(a) consistent with the Authority's interpretation that its statutory objective requires it to promote workable or effective competition (and not "strong" competition);[14] and

(b) appropriately focussed on preventing the exercise of market power.

Uncertainty with the proposed standard

20. Our concern is not just that the proposal reflects a regulatory approach that is inappropriate for competitive markets, but that it will be complex, difficult and contentious to ascertain what an allowable offer actually is in any given case.

21. The proposal identifies the standard required of a party submitting offers in subclauses (1) and (2). It then sets out the purpose of the clause – to ensure that offers do not exceed associated economic costs (by too much or for too long), against an overall question of economic efficiency (in subclause (3)). It is inevitable that the purpose statement will be used as the test for assessing whether offer conduct meets the standard under subclauses (1) and (2).

22. As discussed above, it will be an uncertain and complex standard. First, determining "economic costs" will be contentious, in the same way as determining input methodologies for "efficient costs" was highly contentious under Part 4 of the Commerce Act. Second, as MDAG has recognised, the "too much" of "for too long" is "unavoidably a matter of judgement".[15]

23. The purpose clause will therefore be an ineffective means to determine whether offer conduct is consistent with a market in which no generator has market power.

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[12] *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289, at [18]-[20].
[13] Electricity Authority, "High Prices on 2 June 2016: Market Performance Review", 8 December 2017, at [9.1].
[14] Electricity Authority, "Interpretation of the Authority's statutory objective", 14 February 2011, at [A.29].
[15] *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289, at [15].

24. In any event, the real world issue is not whether prices are above costs for too long or too much – a substantial increase in price is only of concern to the extent that it occurs due to a generator taking advantage of transient market power – which may only be one or two trading periods.

The standard will not be refined through litigation

25. MDAG appears comfortable to leave the proposed standard as being very uncertain on the basis that it will be further refined and defined through litigation and precedent established by the Court. We strongly disagree with this approach.

26. First, the process for taking Code related matters to the courts is unlikely to help clarify how uncertain Code provisions should be applied. Appeals to the High Court are only available where:

(a) the process the Authority has taken to review the Code is alleged to be unlawful (i.e. judicial review); or

(b) there is an appeal on a question of law following a decision by the Authority or Rulings Panel.

27. Unlike Part 4 of the Commerce Act, there is no merits review. This means that, in general terms, a Court will only be able to consider whether the Authority's or Ruling Panel's application of the Code was permissible as a matter of law. Unless the decision-maker incorrectly interprets the law, the threshold for overturning its decision based on the evidence before it is extremely high. It is therefore unlikely that the Courts will be in a position to help clarify how economic costs should be determined under the new provisions – they will only be in a position to intervene if the Authority or Rulings Panel get things materially wrong. It can also be expected that, in the absence of merits review, Courts will exhibit strong deference to the expert regulator's decisions.

28. Second, it is poor regulatory practice to draft amendments that will produce material industry uncertainty on the basis that they can subsequently be clarified by the courts. The Treasury has published the Government's expectations for the design of regulatory systems, which includes (among other things), the need for a regulatory system to have:[16]

(a) processes that produce predictable and consistent outcomes for regulated parties across time and place;

(b) sets out legal obligations and regulator expectations and practices in ways that are easy to find, easy to navigate, and clear and easy to understand.

29. The intention to leave it to the courts to provide clarity could produce the following unintended consequences:

(a) conduct counter to the Authority's objectives (inefficient for those erring on the side of caution), given that participants are unclear about the Authority's expectations;

[16] New Zealand Treasury, "Government Expectations for Good Regulatory Practice", April 2017, at 2.

(b) participants being unfairly punished by the Authority in order to send a message, or establish a precedent for others;

(c) unnecessary and expensive litigation and clogging of our judicial systems as participants seek to obtain clarity.

Scope of proposal

30. MDAG's proposal would apply to all offers into the electricity spot market by all generators and ancillary service agents.

31. As discussed above, 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 are able to exercise market power. We therefore do not understand why it nevertheless believes the proposal should apply to all offers.

32. There are currently narrow circumstances in which generators are not constrained by competitive forces. In 2012, WAG did not identify any specific efficiency losses relating to pivotal supplier situations, but indicated that there was "potential for material efficiency losses to arise in some scenarios".[17]

33. The Authority's analysis suggests net pivotal situations are very rare at an Island and national level, occurring in between 0 and 1% of trading periods in recent years. As such, an approach to addressing this problem that applies to 100% of trading periods at all locations is difficult to justify in practice.[18]

34. In Genesis' case, local pivotal situations typically arise at Waikaremoana 0.2% of the time, and at Tekapo A 2% of the time.[19] We consider that rules aimed at addressing these situations should be appropriately targeted, rather than attempting to prevent market power from being exercised in net pivotal situations with a catch-all approach that applies at all times and at every location.

35. Since the introduction of the HSOTC provisions, there have been two compliance investigations, both of which related to alleged misuse of a pivotal position. It is clear that the problem only exists in a small proportion of the already rare trading periods when generators have market power. The solution should therefore *not* apply to all offers into the electricity spot market at all times.

36. The original recommendation for the HSOTC provision was that it should only apply to suppliers when they are pivotal. The Authority instead decided to apply the requirement at all times, on the basis that limiting the provision to pivotal supplier situations would:[20]

(a) fail to capture the full efficiency benefits of the proposal; and

(b) require participants to know when they are going to be pivotal.

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[17] Wholesale Advisory Group, "Pricing in Pivotal Supplier Situations: A WAG Discussion Paper", 27 May 2013, at ii.
[18] Discussion paper, fig. 3
[19] Discussion paper, at 32.
[20] Discussion Paper, at 51.

37. MDAG applies this same reasoning to the current proposal, and therefore intends for the proposed standard to not be limited to pivotal or net pivotal supply. The HSOTC standard, and the current proposal, should not be considered in the same light. While it is expected that *every* offer would reflect a high standard of trading conduct, it is not expected that, in a workably competitive market, every offer would reflect the economic costs of generation.

38. We do not agree that this is sufficient reason to apply a blanket standard to all trading periods. If the issue is that participants would not know when they were going to be pivotal, then that should reduce any ability to take advantage of market power. Participants would instead price according to a competitive market that they (at the time of placing the offer) thought that they were operating within.

39. In any event, any assessment of conduct will happen after the trading period(s) in question. The question will not be whether the generator knew it was pivotal or not. Rather, if it was pivotal, the question will be whether there is evidence that it took advantage of market power.

40. We understand that MDAG's intent is that, technically, the proposal will apply to all offers in all trading periods, but that it will only have a practical effect on offers in pivotal situations. This is reflected in MDAG's cost benefit assessment, which does not consider a scenario other than through a pivotal supplier.[21] We do not consider that it is appropriate to justify the broad scope of the application of the provision on the basis that enforcement would be limited to serious cases – especially when the proposed standard is a price control type provision, as discussed above.

41. Further, it makes little sense to review an offer made in a competitive market (i.e. by a generator when it is non-pivotal) for consistency against an offer that the generator would have made had it not been able to exercise significant market power. In that case, the factual and counterfactual scenarios are the same.

42. The proposal also ignores one of the key economic and physical characteristics of the New Zealand electricity system, that is, that the vast majority of electricity is generated by plant owned by firms with multiple generators, and that these companies' portfolios are diverse by geography and fuel type.

43. Genesis accepts MDAG's intention, in part, is to limit generators' ability to manage basis risk through their offers. However, Genesis does not believe it is desirable to limit a generator's ability to take a portfolio-wide view of its economic cost of generation.

44. Taking a portfolio-wide view of generation cost 'smooths' offers over time, and lessens the likelihood of extreme high prices at given locations. Indeed, a generator's view of the future value of a unit of fuel/generation will naturally be informed by the alternatives available within its portfolio, in a similar way to how judgements are made on whether to generate oneself or buy from the market.

45. MDAG's proposal, as drafted, could have the perverse outcome of extremely high prices during a smaller number of trading periods as generators attempt to recover costs on a plant-by-plant basis.

[21] Discussion Paper, at 55.

46. Genesis is therefore concerned that the proposed rules risk replicating some of the issues the existing HSOTC provisions set out to resolve, namely, a reluctance to compete on a nationwide basis due to the risk of intolerably high prices in certain locations. Although options are available to manage this risk, these too carry costs that participants may be unwilling to bear relative to the alternative of simply directing their competitive energy elsewhere.

47. A system-wide view of economic cost ameliorates this issue, and can be accommodated within an effective set of rules governing trading conduct in net-pivotal situations while still addressing the problem MDAG is seeking to solve.

48. Genesis was surprised at MDAG's conclusion that the opportunity cost of water "tends to have a wider range of variation than for thermal fuel"[22], and we identified little empirical evidence within the paper to support this assertion.

49. The variation between a current value, and an expectation of future value will be aligned, regardless of the fuel. While whether the fuel in question is water or thermal fuel will have an impact on margins, the overall quantum of the *variation* between current and (expected) future value will be very similar or the same.

50. Furthermore, thermal fuels are subject to a range of variables that give rise to variations between current and (expected) future value that do not apply to water. This is particularly true of those fuels traded internationally. These variables only increase where plants have a choice of fuel, and where there are competing uses (and values) for that fuel in the wider economy.

51. Little consideration is also given to carbon pricing. It is true the cost of carbon impacts upon assumptions of future value regardless of fuel type. However, it appears quite differently whether the generator is using thermal fuel (where variations in carbon prices appear principally as an increase or decrease in input costs) or water (where variations appear as an increase or decrease in profits received). This is a material input into assumptions of future value.

Cost benefit analysis

52. MDAG acknowledges that a full quantitative cost benefit analysis would be difficult to produce, because it would be influenced by subjective judgements about participant behaviour. Genesis agrees that there are inherent difficulties but given the importance of the proposed change, suggests that MDAG should seek to do so.

53. We consider that a qualitative assessment, like that which supports MDAG's proposal, presents the same challenges. It is therefore difficult to understand why MDAG elected to carry out a qualitative assessment only. Both a qualitative and quantitative exercise would provide a stronger evidence base for discussion/debate, potential disagreements over the assumptions concerning participants' behaviour notwithstanding.

54. Genesis considers that the proposed Code change has potentially significant implications for market participants, well beyond the intention of preventing the exercise of unfettered market power where this exists. Therefore, we consider it is

[22] Discussion paper, at 252

right for a proper CBA to be conducted that attempts to quantify the impacts of the proposal.

55. The paper claims the proposal will deliver benefits through purchasers not diverting resources into managing risks of inefficiently high prices. However, the proposal underestimates the countervailing (potentially greater) cost of generators offering at inefficiently low prices, due to the uncertainty associated with falling foul of the too much, too long standard as set out earlier.

56. These costs are two-fold. There is the immediate cost of foregone revenue as a result of offering at below an efficient level, and the longer-term cost of inefficiently delayed generation investment because the market is not sending the appropriate price signals. The cost of the associated increase in risks to security is impossible to quantify, but could reasonably be expected to be significant.

57. MDAG highlights that "smaller or non-integrated parties may have greater difficulty in managing spot price risk and in buying hedge cover on acceptable terms".[23] Genesis considers that this is a disadvantage faced by participants who choose a particular business model, and is balanced by the advantages these models have in other areas. It is therefore not a problem that regulation should seek to solve.

58. The MDAG states:

> these parties can be expected to have less interest in preserving existing industry structures and processes (as compared to established players), they can represent an important source of new ideas and competitive pressure.[24]

This contention is offered without evidence, quantitative or otherwise. Genesis does not accept that this assertion can reasonably be assumed as fact, especially to support an argument for regulatory reform.

59. MDAG considers additional staffing costs for the Authority to be 'nil'[25]. We suggest, however, that broadening the scope of the rules as proposed has the potential to materially increase the staff time and resource required to respond to alleged breaches, particularly given that MDAG anticipates litigation through the Courts as discussed above.

60. MDAG considers staffing costs for participants to be 'minimal'[26]. As above, Genesis considers broadening the scope of the rules as proposed has the potential to materially increase the staff time and resource required to respond to and investigate alleged breaches (regardless of their merit).

61. Broadening the scope of the regulations as proposed will, in our view, almost certainly result in an increase in the number of breaches alleged. These allegations will need to be evaluated regardless of their merit, and could potentially proceed to investigations despite resting on tenuous grounds.

[23] Discussion paper, at 278.
[24] Discussion paper, at 278.
[25] Discussion paper, Table 5.
[26] Discussion paper, Table 5.

Alternative approach

62. Genesis agrees with the concept that MDAG is seeking to implement. That is, generators should not be able to exercise unfettered market power when making offers into the market.

63. Where we differ is how that concept is best implemented. As discussed above, Genesis believes the basic standard should be that offers made while pivotal should be generally consistent with offers made when not pivotal. If conduct provisions work effectively, offers, and therefore prices, would not increase as a result of participant behaviour in relation to a temporary absence of competition.[27]

64. We appreciate that, in some instances, generators are pivotal more often than not. An example is some nodes in the South Island, for which Meridian is pivotal almost 100% of the time. This means that establishing a counterfactual that is defined by non-pivotal offers could be difficult in those cases. However, we think it is better for there to be some uncertainty as to how that narrow range of circumstances will be addressed under the new Code provisions, rather than to create uncertainty for the entire market by establishing a new and materially uncertain standard that applies to all offers.

65. Genesis therefore proposes that clause 13.5A be amended to:

(a) remove the high standard of trading conduct requirement and safe harbour provisions; and

(b) keep the existing definition of "pivotal"; and

(c) require offers from generators (and ancillary service agents) in trading periods where those participants are pivotal or net pivotal, to be consistent with offers that would have been made if market power could not have been exercised; and

(d) like the UTS provisions in the Code, set out non-exhaustive examples of offer conduct that is non-compliant.

66. Specifically, Genesis' proposal for the new wording for clause 13.5A is as follows:

13.5A Conduct in relation to generators' offers and ancillary service agents' reserve offers

(1) Where a pivotal generator submits or revises an offer for a point of connection to the grid, that offer must be consistent with offers that the generator would have made where no generator could exercise significant market power in relation to that point of connection to the grid for that trading period.

(2) Where a pivotal ancillary service agent submits or revises a reserve offer for a point of connection to the grid (including an interruptible load group GXP), that offer must be consistent with reserve offers that the ancillary service agent would have made where no ancillary service agent could exercise significant market power in relation to that point of connection to the grid for that trading period.

[27] Wholesale Advisory Group, "Pricing in Pivotal Supplier Situations: A WAG Discussion Paper", 27 May 2013, at [6.2.10].

(3) The following are examples (but not an exhaustive list) of what the Authority may consider to constitute a breach of subclause (1) and/or (2) by a pivotal generator or ancillary service agent:

(a) withholding capacity to extend the number of trading periods in which the participant is pivotal;

(b) making late changes to offer prices that are not explained by legitimate operational requirements or constraints; or

(c) an unexplained increase in offer price compared to adjacent trading periods, or comparable trading periods where that participant is not pivotal.

67. This is a fair compromise – ensuring that the market remains competitive (which produces the best long-term benefits to consumers), providing clarity on what is required to comply, and ensuring that offer conduct remains of a high standard.

Assessment of the alternative proposal

68. We have assessed our alternative option against the Code amendment principles:[28]

(a) *Lawful* – the proposal is lawful, and is consistent with the statutory objective to further strengthen competition to promote net long-term benefits for consumers.

(b) *Addresses market failure* – market failure only exists when participants have the ability to take advantage of market power when making offers when they are pivotal. The existing HSOTC provision fails to directly deal with this type of market failure. Our proposal specifically addresses this market failure.

(c) *Quantitative assessment* – we do not intend to undertake a full cost benefit analysis to assess this option, but are confident that our proposal would produce economic efficiencies, on the basis that it allows a competitive market to discover efficient prices, in all instances other than when there is market failure. We support the Authority conducting a full cost benefit analysis of this alternative proposal through its usual consultation process.

(d) *Preferences for small-scale 'trial and error' options* – rather than immediately implementing a conduct obligation that reflects the economic costs of generation, the starting point of our proposal is a standard or expectation of conduct, with clear examples of when that standard has not been met. The application and scope of the standard can be targeted and refined by adding or removing from the "problem areas".

(e) *Preference for greater competition* – in the case of most offers, sufficient competition already exists and this competition should be encouraged in preference to an arbitrary "price cap" that reflects an uncertain measure of economic costs.

[28] Electricity Authority, "Consultation Charter", 20 December 2010, at [4]-[6].

(f) *Preference for market solutions* – this proposal suggests a targeted approach to directly address the source of market failure (i.e. offers in pivotal situations), rather than a blanket standard that would apply to all offers. It allows the competitive market to operate as intended to the greatest extent possible.

(g) *Preference for flexibility to allow innovation* – this option would allow industry participants the flexibility that competitive markets provide, and only constrain that flexibility when circumstances exist where market power can be exercised.

(h) *Preference for non-prescriptive options* – this option clarifies the offer conduct that is unacceptable (i.e. what not to do), rather than prescribing offer conduct (or price) that is acceptable. The outcome sought is that a generator is unable to take advantage of market power, but the option doesn't specify the pricing behaviour required in order to achieve this.

69. This option can also be assessed against MDAG's suggested criteria:

(a) *Degree of legal certainty* – rather than waiting for certainty through litigation (which may never be achieved), the examples of "problem areas" will provide guidance to participants on what is (through what is not) acceptable offer conduct.

(b) *Effectiveness in "trapping" unwanted behaviour* – unwanted behaviour would be directly targeted (and therefore trapped).

(c) *Low chance of unintended consequences* – the option is narrowed to solve the problem at hand (i.e. when generators are pivotal), rather than a blanket approach that would seek to control all offers. A solution that is narrow in scope is less likely to impact other direction or regulation.

(d) *Readily able to be updated or refined* – by adding or removing from the list of "problem areas" (in subclause (c)) the application of the obligation could alter direction to become more targeted. The Authority, and the Rulings Panel, would be able to exercise discretion in enforcement (within reason).

(e) *Likely to cover other currently unknown unwanted behaviours* – MDAG's specific concerns include market power abuse, insider trading, market manipulation, collusion and price fixing, and predatory pricing. These could be specifically identified as "problem areas" (in subclause (c)) that are examples of trading conduct that would not occur if the participant was not pivotal. We consider that the "taking advantage of transient market power" catch-all would also capture currently unknown behaviour.

(f) *Support of other relevant electricity markets and regulations* – as discussed above, the spot market does not operate in isolation. Genesis' solution will allow the spot and hedge markets to complement each other to the greatest extent possible to allow generators to recover efficient costs over time.

Process

71. MDAG states the Authority Board has noted that the Authority can move directly to changing the Code without its own consultation process, if it is satisfied that there has been adequate prior consultation including by an advisory group such as MDAG. Genesis does not consider this would be an appropriate course of action in this case.

72. Genesis is appreciative of the consultative approach the MDAG has taken so far, including through industry workshops, extending the consultation deadlines in recognition of the disruption caused by the national response to Covid-19, and providing advance notice of the proposed period for cross submissions.

73. However, rather than treat these exercises as a comprehensive consultation process appropriate to support a Code change, Genesis considers the proposed Code change that emerges should then be tested against a full cost benefit analysis and afforded the oversight and best practice regulatory scrutiny available under the Authority's full Code change process. As we have discussed with the Authority previously, the absence of guidelines supporting the current HSOTC rules is a weakness of the current regime. The full consultation process should also include consultation on proposed guidelines to help participants interpret and apply the Code change.

74. MDAG notes that the current HSOTC provisions emerged from a "relatively conventional" five stage rule-making process beginning in mid-2012. It is unclear why the Authority or MDAG would advocate an unconventional or extraordinary process in relation to reviewing and potentially amending the provisions now.

75. We note that several industry participants have also expressed this view in workshops.

76. As set out in 25 to 29 above, Genesis does not agree that the courts are an appropriate, or even in this case, effective avenue to remedy uncertainties in the proposed Code change. Rather, it is preferable to offer participants regulatory certainty through the usual process.

77. Furthermore, the logic behind an accelerated process is unclear. The MDAG has been working on the HSOTC provisions for almost 24 months today[29]. Genesis considers it is preferable to lock in the benefits of this good work to ensure an enduring solution, rather than risk introducing an unworkable or inappropriate standard through hasty implementation.

[29] Discussion paper, p3, iii