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TRUSTPOWER SUBMISSION: "HIGH STANDARD OF TRADING CONDUCT" PROVISIONS: A REVIEW BY THE MARKET DEVELOPMENT ADVISORY GROUP DISCUSSION PAPER

On 25 February, the Market Development Advisory Group (**MDAG**) published its discussion paper *"High standard of trading conduct" provisions: a review by the Market Development Advisory Group* (**Discussion Paper**).

This paper was published in response to the 2017 request from the Electricity Authority for MDAG to review the high standard of trading conduct provisions contained within the Electricity Industry Participation Code 2010.

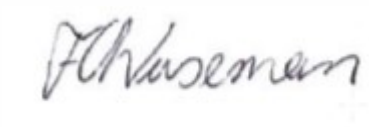
MDAG have encouraged relevant industry participants to respond to the details contained within the Discussion Paper, as well as identifying any aspects of the proposal that have not been considered.

Trustpower wishes to thank the MDAG for the opportunity to provide our views on their preliminary thoughts on this matter and encourage MDAG to continue to engage with the industry as these thoughts are further refined and tested in advance of providing final advice to the Electricity Authority.

Trustpower's detailed submission is provided in Appendix 1. Kindly note that we have responded in the form of a logic diagram, rather than the usual extended written form.

For any questions relating to the material in this submission, please contact me on 027 549 9330.

Kind regards



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Appendix 1 Trustpower's Response to: *"High Standard of Trading Conduct Provisions": A Review by the MDAG - Discussion Paper*

BACKGROUND: The government has introduced a number of changes to address the competitiveness of the wholesale market. These include two significant restructures of ECNZ, the transfer of the Tekapo power scheme from Meridian Energy to Genesis Energy, and mandated contractual requirements. The Electricity Authority (**the EA**) (and its predecessor) have also introduced and amended a range of rules to promote competitive entry and discipline market behaviour. These include the high standard of trading conduct (**HSOTC**) provisions and the undesirable trading situation (**UTS**) rules. The EA has specific market monitoring powers and has developed strong capability in this area. It can amend the Code on its own volition, and in certain circumstances, without consultation, to meet its statutory objective. This raises an important preliminary question of how all these structural and regulatory changes work together *ex ante* (to avoid or deter) and *ex post* (to remedy) any cases of market power abuse for the long-term interests of consumers.

CONTEXT: The Market Development Advisory Group (**MDAG)** has been asked to review the HSOTC provisions in the Code and advise if they are adequate to promote the EA's statutory objective, or whether changes are required to better promote outcomes consistent with workable competition. The provisions require generators to ensure they comply with a HSOTC when making offers, and specify safe harbour behaviour. MDAG proposes replacing these provisions with a requirement that all offers must be made in a manner that is consistent with offers that would be made in a market where there is no significant market power (**NSMP)**. This is said to provide positive benefits through being a "clearer standard".

OVERVIEW: Trustpower welcomes the opportunity to participate in this consultation process and thanks MDAG for sharing the expert advice on which it has reached its preliminary views. We found the discussion paper very helpful, however, we think that further work needs to be done before a final recommendation is made to the EA. This additional work includes: (1) the development of case studies to demonstrate how the proposed NSMP rules might apply "at the trading desk" to see if, in fact, they will provide a "clearer standard"; (2) a new cost benefit analysis (**CBA**) which addresses the risk that, although well-intentioned, the NSMP provisions increase regulatory uncertainty and risk; and (3) consideration of whether it would be more consistent with the EA's statutory objective to delete the HSOTC provisions altogether and rely on other methods of managing market power.

Trustpower is rarely pivotal, however we are keen to avoid regulatory overreach and a pancaking of obligations which both overlap and are difficult to interpret and apply. Such provisions will undoubtedly affect long term affordability and, as such, may not be in the best interests of consumers. To be clear, we do not support market arrangements being in place that would enable an abuse of market power. We regard the EA's market monitoring and rule-making powers and the current UTS provisions as a significant discipline on market conduct.

A preliminary question that is alluded to, but not fully addressed, in the discussion paper is what the EA's statutory objective requires in relation to pricing by pivotal generators.

Trustpower agrees that the HSOTC provisions do not directly reflect the economic tests that were used in the EA's market review report. We invite MDAG, however, to reconsider its proposed solution along with the broader question of whether, in fact, the HSOTC provisions are required at all. There is a risk that the proposal will replace one unclear test with another and potentially undermine previous structural reforms that were designed to give different views on the value of water storage. There is also a risk that the proposal might lead to vexatious claims of rule breaches and/or opportunistic reliance on regulatory hedges. For the reasons set out we think more consultation is required on the options analysis.

We make a few suggestions with respect to the process to date and going forwards. We do not support the adoption of the proposal by the EA without further consultation.

We think the statutory objective requires the promotion of competition not the achievement of particular price outcomes in pivotal periods.

- The EA's primary task is to promote competition in the wholesale market (including the spot, hedge and ancillary services markets).
- This involves the provision of an appropriate platform(s) for competition to occur and allow for intervention if there is evidence that competition is not occurring. The discussion paper contains a good summary of the range of other options available to mitigate market power.
- Competition is not about efficient prices, although efficient prices are an indicator of robust competition.
- 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.

We are uncertain, based on the evidence MDAG has presented, that there is a problem to address.

- The discussion paper records that the current provisions were introduced by the EA to improve the efficiency of prices in pivotal supplier situations and, thereby, improve consumer confidence (p17). As noted in the previous column this may be the wrong test.
- The paper expresses the view that that the HSOTC provisions are an obtuse and relatively indirect way of achieving this objective.
- The paper also notes that for ten years no such rules were in place (2004 to 2014) and, since they were introduced, there has been only one substantive enforcement action.
- As Aristotle once said, "*one swallow does not a summer make*".
- We also note that New Zealand has adopted a "gold-standard" approach

We acknowledge the legal/economic mismatch but record our traders have not found the rules problematic in practice.

- The discussion paper sets out MDAG's analysis of the legal issues MDAG has identified with the current rules.
- Trustpower had a representative on the Wholesale Advisory Group (**WAG**) when the HSOTC rules were designed and notes the legal material was not in front of the WAG when developing its advice.
- This new material does suggest that, from a legal perspective, the current HSOTC provisions might well be an "unfortunate import" (i.e. more suitable to cases of insider trading or market manipulation than a constraint on what are said to be inefficient prices by pivotal generators).

As it stands, we think MDAG is optimistic about the prospects that the new test is clearer.

- MDAG proposes to replace clause 13.5A and B of the Code with a requirement that all offers must be made in a manner which is consistent with a market where no generator could exercise significant market power.
- This would require the ex-post development of a hypothetical counterfactual where the regulator determines what the outcome of strong competition would have been.
- We consider this proposition is fraught with risk for generators making offers to the market as perfect foresight is not possible and allowances for uncertainties that parties face in the real world would be required.
- The rationale for the transfer of Tekapo A and B from Meridian

We think that more options analysis needs to be undertaken.

- The discussion paper sets out a summary of the options analysis conducted by WAG.
- 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 also note Yarrow's recent advice around the potential adverse impacts of conduct provisions: "*the general problem is that increments in legislation cannot properly be assessed in isolation: the effects that any set of rules and regulations will have on market conduct and performance are generally not separable…. progress towards a more competitive market may be*

A more robust CBA is required for reform of this magnitude.

- Considerable caution needs to be exercised about the assumption that the regulator will be able to determine efficient pricing levels and that, as a consequence, the reform will have considerable benefits.
- At best we think the new test is complex and introduces a high level of uncertainty.
- Investors do not like complexity nor uncertainty. This was evidenced recently by Mike Fuge (ex-Chief Executive for NZ Refining) who stated that these factors add 100 basis points to supply cost in NZ[3].
- In addition to costs associated with higher levels of uncertainty (including legal uncertainty as discussed earlier), we think that the breadth of the proposed NSMP

Affected parties have the right to have their views heard directly by the decision-maker.

- The discussion paper has been prepared by MDAG to meet the statutory test for not requiring further consultation by the EA under section 39(3)(c) of the Act.
- We support advisory groups providing advice to the EA on the options to achieve its regulatory objective and using appropriate consultation processes to develop this advice.
- We also believe that undertaking consultation during the design and development process can result in better quality regulatory proposals that are more likely to achieve their objectives.[5]
- We do not think, however, consultation by an advisory group should be used as a substitute for direct consultation by the decision-maker

- Based on advice from Yarrow (in the papers quoted in the bibliography of the discussion paper) we do not think that the "efficient operation" limb of the statutory objective requires the EA to ensure that prices at all times in all places across all markets are set at the efficient level.
- The task given to the EA is to promote competition (not efficient pricing outcomes). This choice of terminology is deliberate as competition is a process with unpredictable outcomes.
- Yarrow has recently pointed out that this is why regulators are often given the task of promoting workable competition or effective competition. "*Competition means rivalry, and rivalry is a feature of a process. In saying that a process is rivalrous/competitive then, at this level of abstraction there can be no immediate linkage to the outcomes or effects that eventuate.*"[1]
- For this reason, we strongly caution MDAG against moving away from the concept of workable competition, however imprecise.
- This is particularly problematic when the EA has a published a foundation document, outlining its interpretation of its statutory objective, to the effect that its underlying competition benchmark is the attainment of prices which tend over time towards LRMC.
- In our view the question of "how much for how long" in a competitive market cannot be "kicked for touch" as this needs to include a consideration of what the relevant market is (i.e. spot or spot and hedge).
- This needs to be addressed before we know if there is a competition issue that requires addressing and, if so, whether behavioural rules are the best option to address it.

to addressing market power issues at their source via structural solutions.

- This suggests the first issue to be addressed is whether <u>any</u> behavioural rules are required to create workable and effective competition in the wholesale market. To answer this the dimension of time needs to be addressed. We suggest MDAG considers:
  - At what point is regulatory intervention needed to regulate pivotal power?
  - Will premature regulatory intervention crowd out market response?
- We also struggle with the notion that it is consistent with the efficient operation of the industry for a single event to be subject to: (1) a UTS investigation; (2) an HSOTC breach investigation where the EA makes a decision and issues a remedy without a hearing by the Rulings Panel; and (3) a market review which ultimately led to the current consultation. We note this is in addition to potential review under the Commerce Act.
- We would like to understand whether MDAG has considered whether the HSOTC rules could be safely removed altogether given: (1) there has only been one (highly controversial) compliance breach under the current provisions; and (2) the Concept Consulting analysis suggests that the EA's enforcement actions in mid-2017 did not have an appreciable effect on participants behaviour or market outcomes.
- We encourage MDAG to further explore whether the introduction of the HSOTC provisions in 2014 led to any change in behaviour or market outcomes.

- We also acknowledge that the test applied by the EA in its market review following the June 2016 event was economic in nature and, as such, not well aligned with a conduct rule or legal tests.
- From a trading perspective however, we have found the safe harbour provisions to be straightforward and useful.
- Our recollection is that these provisions were developed by WAG sitting around a white board and discussing what situations may occur and what rules should apply.
- We are reluctant to support the replacement of these provisions with a test that is very difficult to understand and apply in real time. We also note that the test would become even more complicated if it was to only apply to net pivotal generators.
- Therefore, we suggest that, as a minimum, MDAG develop some case studies or worked examples of its proposal.

Energy to Genesis Energy was to ensure competition and diversity of views about Waitaki River production, which holds a large portion of the country's storage. It is unclear if MDAG has considered whether these rules would undermine this structural reform.

- The paper says that the test it has formulated derives from the Wellington International Airport (**WIA**) case. This context is very different, however. In the WIA case, a decision had already been made that regulated suppliers were to receive a return of their efficient costs. The exercise was merely to work out the level of those costs.
- Participants in the wholesale market (spot, hedge, ancillary services markets) have no such assurance and, instead, engage in a process of price discovery to assess how best they can cover their costs across all relevant markets. They are entitled to as much clarity as possible over what the "rules of the game" are.
- We welcome the acknowledgement that spot prices need to reach high levels at times to properly reflect efficient economic costs. The examples in paragraphs 139-40, however, are too simplistic and further work is required on how the EA will treat different assessments of the same water.
- We think the so called "definitional or semantic" issues associated with transient pricing power will need to be better addressed to ensure clarity with the EA's foundational view that a long-term view of competition needs to be taken.
- We encourage MDAG to further consider this matter, including developing case studies of how the competitive impacts of short-term price increases may be assessed within the context of the other features of the market (including hedges, DR contracts etc.).

hindered by the conduct of firms with substantial market power, but from my own experience, empirically the greater source of such obstacles is regulation itself."[2]

- In short, we consider that conduct provisions are not the best tool for addressing market power in electricity markets.
- We also note that, if there is problematic market power (a generator's offer prices are too much for too long, with no offsetting hedge contracts), then there are also a number of existing tools to address this issue. These include industry and market monitoring arrangements (including inquiries, studies and reviews), Commerce Act prohibitions, "backstop" UTS provisions, along with past structural reforms.
- Our initial view is that these existing arrangements provide sufficient protection against problematic market power abuse and there may not be a strong enough case for also maintaining the conduct provisions given the significant overlap with the UTS backstop arrangements. We support MDAG further considering this matter.
- The discussion paper also sets out MDAG's brief conclusions on the alternative solutions identified by WAG.
- This analysis, however, is driven by the assumption <u>that a solution needs to be found</u> to the prospect that prices may be inefficient where a generator is pivotal. As explained earlier, we believe that this is not the correct test.

test may lead to higher compliance[4] costs and may encourage vexatious claims of rule breaches and/or risky hedge practices.

- These costs and risks do not appear to have been factored into the CBA, which is relatively high level.
- This might be satisfactory for a minor, insignificant Code change, however, Trustpower believes it is not adequate in this instance as the proposed change is far from inconsequential. It will potentially impact a number of generators and could be interpreted as a significant change to the underlying wholesale market design in New Zealand, particularly if arrangements akin to price controls are introduced.
- We recommend that a new CBA is completed using multiple data points to establish, not just that this change is better than the status quo, but also that it is better than the other options to promote effective wholesale market competition (should there be a finding that this does not presently occur).
- We currently have reservations about whether this proposal would, in fact, deliver net benefits.

(particularly on matters of significance).

- We note that any such process would be contrary to the legitimate expectation stakeholders have based on past proceedings, including when the current HSOTC provisions were developed (a two-part consultation process undertaken by WAG and the EA on pricing in pivotal supplier situations).
- Section 39(1)(a) of the Electricity Industry Act stipulates that, before amending the Code, the EA must publicise a draft of the proposed amendment.
- We strongly suggest a full consultation process by the EA should be undertaken when it publicises the draft of the proposed amendments to the Code. This will allow affected parties to have their views heard directly by the decision maker.

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[1] Yarrow (2019, page 2), Questions relating to the regulation of fibre fixed line access services in New Zealand.
[2] Yarrow (2019, page 13), Questions relating to the regulation of fibre fixed line access services in New Zealand.
[3] Refer to NZ Refining Co TPM Oral Submission, December 2019.
[4] Colleagues in Australia advice that ex-post compliance reviews require: (1) ongoing exemplary documentation of trading decisions as it may need to be referred to at a later time during an investigation; (2) internal resource to collate and explain relevant information for the regulator when an investigation is undertaken.
[5] Guidance Note: Effective Consultation for Impact Analysis, [2019] The Treasury, p. 2 (available at https://treasury.govt.nz/publications/guide/effective-consultation-impact-analysis)