15 December 2020

REVIEW OF THE TRADING CONDUCT PROVISIONS

RECOMMENDATIONS PAPER

MARKET DEVELOPMENT ADVISORY GROUP

Note: This paper has been prepared by the Market Development Advisory Group for the purpose of advising the Electricity Authority. Content should not be interpreted as representing the views or policy of the Electricity Authority.

Preliminary

Acknowledgements

This recommendations paper was prepared by the Market Development Advisory Group (MDAG). The current members of MDAG are:

Tony Baldwin (Chairperson)
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Rebecca Osborne
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MDAG would also like to acknowledge the contribution to the review of the trading conduct provisions in the Code by previous members of MDAG during the period of their membership.

MDAG's role

MDAG[1] was established by the Electricity Authority (Authority) in October 2017. MDAG provides independent advice to the Authority on the development of the Electricity Industry Participation Code 2010 (Code) and market facilitation measures. MDAG focuses its advice on matters relating to the evolution of the 'machinery' of the electricity market. Specifically, under its terms of reference MDAG can advise on:

(a) initiatives to promote efficient pricing in markets and for monopoly services

(b) initiatives to promote efficient management of capacity and energy risks

(c) any other policy matters that the Authority considers appropriate.

Authority request

The Authority has requested the advice of the MDAG in considering issues associated with the High Standard of Trading Conduct (HSOTC) provisions in the Code.

[1] ea.govt.nz. 2017. *Charter, Terms of Reference and Operating Procedures*. [online] Available at: https://www.ea.govt.nz/development/advisory-technical-groups/mdag/charter-and-terms-of-reference/.

Executive summary

Introduction

i. This paper is the third and final instalment in a suite of three papers by the MDAG on its review of the "high standard of trading conduct provisions"[2] in the Code. This third paper sets out our recommendations to the Authority.

ii. The HSOTC provisions were introduced in 2014 to "improve confidence in the efficiency of prices when competitive pressures in the wholesale market are weak".[3] The crux question addressed in our review has been, what if any changes should be made to better achieve the objective?

iii. Our first paper set out our analysis of the problem, the options and our initial proposal.

iv. Following consideration of submissions and cross-submissions, we established two independent evaluation panels to act as proxies for the Rulings Panel or courts. Their task was to interpret and apply the existing code provisions, and our proposed code provisions, to a menu of indicative real-world case studies in an objective and rigorous manner. The purpose of this exercise was to establish on a more empirical and expert basis how the existing and proposed code provisions would likely be interpreted in practice, and in the process learn more of the qualitative and quantitative costs and benefits of the two alternatives.

v. We then consulted with a range of technical drafting experts. We also tested various potential improvements with two members of one of the evaluation panels.

vi. Our second paper followed and it set out our revised proposal, having taken into account submissions, cross-submissions, bilateral consultations and the evaluation panel process.

vii. This third paper sets out our final recommendation taking into account all of the information gathered through this process, including submissions on our second paper.

viii. Our process is illustrated in a timeline on page 7 below.

Problem-definition

ix. In summary, there is clear evidence that current arrangements are not satisfactory, and that reform is warranted:

(a) At various time and locations, parties have the ability and incentives to exercise significant market power in the New Zealand spot market. Generators are frequently gross pivotal across wide areas of the spot market.[4]

[2] Set out in Appendix B of this paper.

[3] Letter from Authority to WAG Chair, 22 June 2012, WAG work plan.

[4] A participant is gross pivotal in a trading period if demand cannot be satisfied without some supply from that party. While gross pivotal suppliers may not have a short-run incentive to raise spot prices due to their contract position, they will nevertheless have a longer term incentive to raise spot prices to increase returns from future hedge contract and/or retail sales. MDAG's February paper also showed that local pivotal supplier situations have occurred in recent times and are likely to continue to arise.

(b) Depending upon supplier behaviour, adverse efficiency impacts could plausibly reach millions of dollars in present value terms for a single local pivotal supplier situation[5]. Wider pivotal supplier situations could also occur and give rise to even larger costs.[6]

(c) The existing HSOTC provisions, which are intended to act as a check on the abuse of market power, lack any clear meaning. One of the evaluation panels described these provisions as a "broken rule". This view is shared among several market participants. For example, Genesis stated "there are occasions where generators have the ability to exercise unfettered market power" and that "reform is justified".[7] Meridian stated that it judged "the current HSOTC provisions to be unworkable".[8]

(d) The Wholesale Advisory Group (WAG) correctly observed that the effectiveness of a conduct obligation would depend on how tightly it targets the underlying economic principles.[9] The existing HSOTC provisions are opaque and do not necessarily translate at law into the economic efficiency framework assumed to date by the Authority.

Options and proposal

x. We considered a range of potential remedial options[10]. At a first principles level, it is clearly better to deal with potential market power structurally *ex ante.*[11] Typically, conduct provisions tend to be not well aligned with participants' incentives and so tend to be comparatively less effective.[12] However, better incentive-aligned options also come with higher costs. Recognising the need for a lower cost approach with net benefits, MDAG focused on developing an improved conduct measure.

xi. Our proposal builds on a counterfactual approach often used in competition law. Further, our proposal locates the core question within the framework of economic efficiency, which is both well established in New Zealand's jurisprudence and much better aligned with the Authority's statutory objective and legislative provisions on what the Code may contain.[13] It also reflects much more closely the framework assumed by the Authority in its approach to date in investigations or reviews involving the existing HSTOC provisions.

Consideration of participants' views

xii. Extensive input from market participants has been greatly appreciated and helped us considerably in developing and critiquing our proposal as it evolved. We carefully considered all submissions and cross-submissions. We also gained a great deal from direct consultations with the market participants at various workshops and three rounds of bilateral discussions.

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[5] See Part E of this paper.

[6] See our February paper at 168-181 and Annex 4 (para 309).

[7] Genesis submission on our February paper at page 1.

[8] Meridian submission on our February paper at page 1.

[9] WAG, May 2013 at 4.5.40 and 4.5.41.

[10] See our February paper at Part D.

[11] Joskow, 2007, Lessons Learned from Electricity Market Liberalization, page 12 - http://econwww.mit.edu/files/2093 cited in Investigation Report: Commerce Act – Electricity Investigation", Commerce Commission 21 May 2009 at 665.

[12] As noted in our February paper at pars 106-108.

[13] Section 32(1)(a) of the Electricity Industry Act 2010, "(1) The Code may contain any provisions that are consistent with the objective of the Authority and are necessary or desirable to promote any or all of the following: (a) competition in the electricity industry" – see the Electricity Authority's "Interpretation of the Authority's Statutory Objective", 14 February 2011 at paras A20 - 31 We consider that our proposal also better aligns with section 32(1)(b) and (c) in that an optimal level of reliability of supply and efficient operation of the electricity industry are necessary outcomes of economic efficiency

xiii. In this paper[14], we have endeavoured to respond to each of the key points raised by submitters. A call for guidelines and a full quantitative cost benefit analysis (CBA) gained prominence in some submissions and therefore it may be helpful to address these points briefly in this executive summary[15].

Cost-benefit analysis

xiv. Early on, we set out to undertake a quantitative CBA of our proposal. On closer consideration, however, it became apparent that such an approach would not be informative in this case. The outcomes would only be as meaningful as the assumptions upon which they were based. Key among those assumptions would be how the Rulings Panel or courts would apply the existing and proposed rules, and how parties would behave[16] in the light of their view of how the Rulings Panel or courts would apply the two rules. There is simply no reliable evidence-based quantified data on which to base those assumptions for the purposes of a fully quantified CBA.

xv. In short, a putatively quantitative CBA would simply 'play back' speculative and subjective behavioural assumptions, but in a way that is less transparent and open to scrutiny than in a qualitative analysis. Our approach has therefore been to do a qualitative CBA, informed by the evidence produced from the evaluation panels process, together with quantitative sensitivity analysis in relation to a selection of actual examples of local pivotal market power. We consider this to be a relatively robust and transparent approach to assessing costs and benefits in relation to our proposal.

Guidelines

xvi. Some submitters have called for guidelines with specific examples of when offers may be in breach of our proposed rule. We understand the desire for that sort of 'black and white' manual, however we have concluded after careful consideration that it is not practical. It is also important to keep in mind that our proposed rule is based on a well-established framework (of effective competition causing economic efficiency), not a series of discrete prescriptions for different fact situations. Trying to create a manual covering all likely fact situations would give rise to an almost infinite number of cases and permutations without necessarily answering the next fact situation that a trader may be dealing with.

xvii. The problem of uncertainty is not with our proposed rule; rather, it arises from the underlying uncertainty in gauging if and when competition has reached a level of weakness that it causes outcomes adverse to the market as a whole and how it impacts on economic efficiency. This boundary between sufficient and insufficient competition is inescapably a matter of judgement, not a mechanical formula.

xviii. What counts is understanding and applying the framework, which market participants can reasonably be expected to set out in internal corporate policies with guidance from their advisers. Each market participant will need to apply the rule to its particular situation and mix of activities.

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[14] In Parts D and E below.

[15] These matters are discussed further in Parts C and D below.

[16] This includes the degree to which parties would change their offers relative to the offers they would have made (i) absent any rule compared to (ii) with the existing rule and (iii) without the proposed rule; and (iv) as between (ii) and (iii).As noted in our February paper at para 281, footnote 236: Quantifying the benefits would also require predicting the likely frequency and duration of these future pivotal supplier situations (as well as the quantity of load affected). While these predictions can be based on what has happened in the past and what we know about the future, these predictions would also add to the uncertainty around the benefit estimation.

xix. The Authority can assist by ensuring that market participants can readily access precedents established by the Rulings Panel or the courts, or indeed by the Authority in deciding whether or not to bring a case for an alleged breach of the proposed rule following a "please explain" request.

Improve deterrence

xx. Deterrence is central to the effectiveness of any rule. Deterrence would be enhanced for our proposed rule by publishing any compliance actions (including cases that have been considered but not progressed), and by making the threat of enforcement more credible. To this end, our recommendations include more rigorous compliance monitoring by the Authority, particularly when competition is weak or absent, and a review of penalties for breaches of the proposed provisions.

Make rule technology-neutral

xxi. MDAG has previously recommended that the Authority undertake a first-principles ('root and branches') review of the Code to make it technology-neutral.[17] If and when that review is undertaken, references to "generators" and "ancillary service agents" in our proposed rule should be reviewed to make the rule technology-neutral, as appropriate.

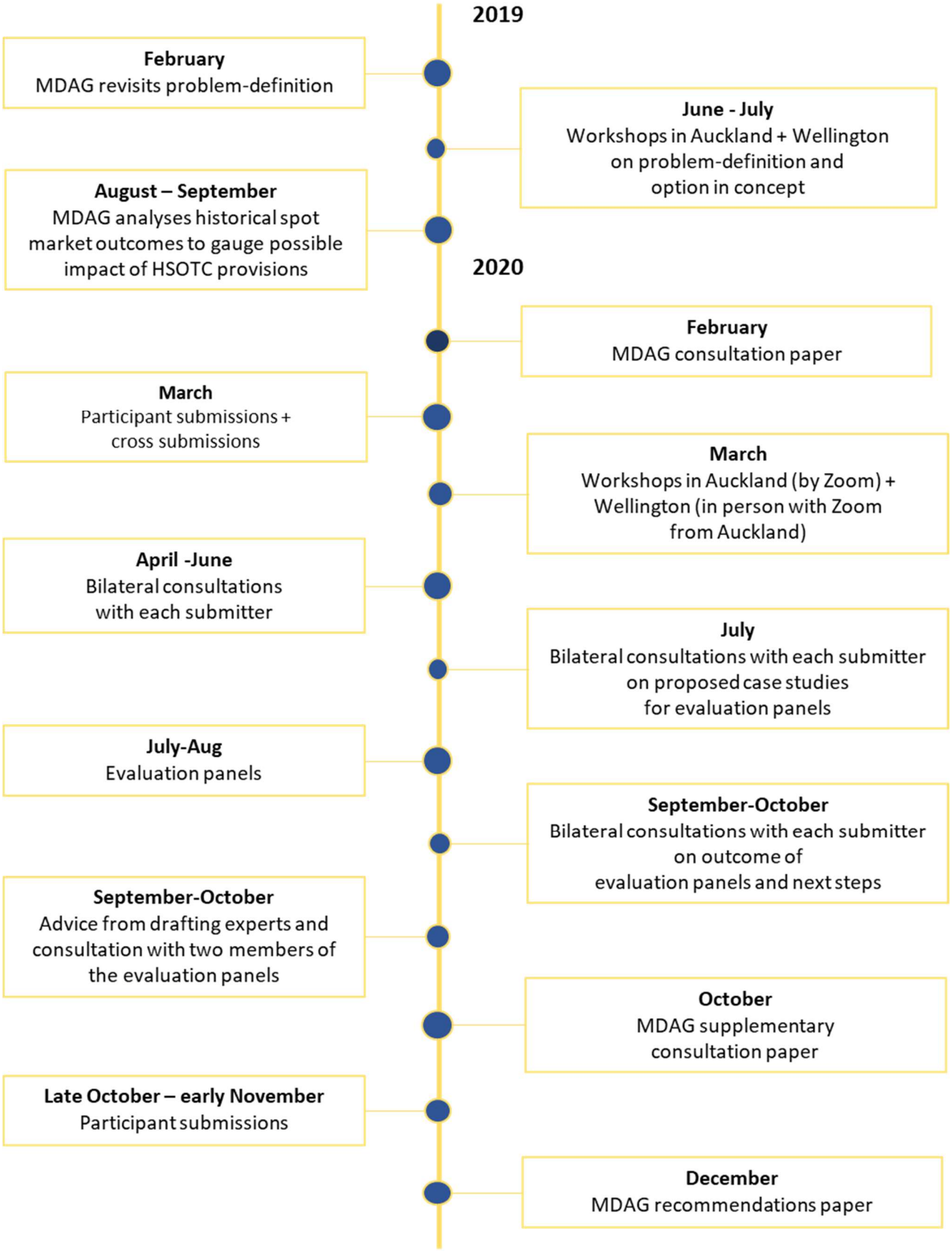
Conclusion

xxii. We are pleased to present the Authority with our final report on our review of the high standard of trading conduct provisions in the Code. It is the unanimous view of MDAG's members that our recommended code change is considerably better than the existing HSOTC provisions and should be put in place as an improved mechanism for mitigating the risks of significant market power.

[17] "Enabling participation of new generating technologies in the wholesale electricity market", Market Development Advisory Group, Recommendations Paper, June 2020. We highlighted that a piece-meal approach is likely to give rise to significant barriers to Code coherence and optimisation over time. Available at https://www.ea.govt.nz/development/work-programme/evolving-tech-business/participation-of-new-generating-technologies-in-the-wholesale-market/.

Process timeline

xxiii. A summary of our process set out in a timeline is as follows:



Recommendations

On a unanimous basis, MDAG recommends that the Authority replace the current high standard of trading conduct provisions in the Code (clauses 13.5A and 13.5B and the definition of "pivotal" in Part 1 of the Code) with the following:

(1) In the spot market –

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

(b) however, there may be locations where, or periods when, one or more generators, or ancillary service agents, as the case may be, has significant market power.

(2) Accordingly –

(a) where a **generator** submits or revises an **offer**, that offer must be consistent with the **offer** that the **generator,** acting rationally, would have made if no **generator** could exercise significant market power at the **point of connection** to the **grid** and in the **trading period** to which the **offer** relates;

(b) where an **ancillary service agent** submits or revises a **reserve offer**, that **offer** must be consistent with the **reserve offer** that the **ancillary service agent**, acting rationally, would have made if no **ancillary service agent** could exercise significant market power at the **point of connection** to the **grid** and in the **trading period** to which the **reserve offer** relates;

(3) For the purposes of this clause –

(a) market power becomes significant when its exercise would have a net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency;

(b) "spot market" has the same meaning as **wholesale market** except that it excludes the hedge market for **electricity** (including the market for **FTRs**).

Achieving the Authority's policy objective in this matter will depend crucially on improved monitoring and enforcement. MDAG therefore also unanimously recommends strongly that the Authority:

(a) put in place a more active monitoring regime of market performance, complemented by frequent 'please explain' notifications;

(b) better resource the Authority's monitoring, enforcement and compliance arms; and

(c) engage with the Ministry of Business, Innovation and Employment (MBIE), as the Ministry responsible for administering the Electricity Industry Act 2010, to consider raising the maximum penalty applicable for breaches of the recommended replacement provisions.

Contents

Part A: Introduction and initial proposal

Where this paper fits

1. This paper is the third and final instalment in a suite of three papers by the MDAG on its review of the HSOTC provisions in the Code.[18]

2. Our first paper of February 2020[19] set out our analysis of the problem, the options and our proposal. Our paper of October 2020[20] set out our amended proposal, having taken into account submissions, cross-submissions, bilateral consultations and the evaluation panel process (described further below).

3. This third paper sets out our recommendations to the Authority, having taken into account submissions on our October paper. This paper should be read in conjunction with the previous two papers.

4. We consider that this body of work satisfies the requirements of our terms of reference.

Market context

5. For electricity markets to work effectively for the long-term benefit of consumers,[21] they need to produce efficient price signals about production and consumption of electricity. High prices are essential for this when they reflect supply shortages but can undermine efficiency if they are caused by suppliers misusing situations where competitive pressure is weak.

6. High prices arising from weak competitive pressure can undermine confidence in pricing outcomes and cause efficiency losses as parties take actions to reduce their exposure to this risk. Well-functioning electricity markets incorporate mechanisms to prevent abuse of market power but allow prices to rise to signal scarcity, while also ensuring that effective mechanisms are available to manage exposure to high prices, such as liquid hedge markets.

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[18] Market Development Advisory Group work plan for 2017/18 – request to undertake Review of spot market trading conduct provisions project, letter from Carl Hansen, Chief Executive, Electricity Authority, to James Moulder, Chair, MDAG, 20 November 2017, available at https://www.ea.govt.nz/dmsdocument/22983-letter-to-mdag-2017-18-work-plan-request-to-add-trading-conduct-project.

[19] "High standard of trading conduct" provisions: A review by the Market Development Advisory Group, Discussion Paper, 25 February 2020. [online] Available at: https://www.ea.govt.nz/assets/dms-assets/26/26404High-Standard-of-Trading-conduct-MDAG-discussion-paper-on-pivotal.pdf **(referred to in this paper as 'our February paper' or 'the February paper')** .

[20] "Review of the Trading Conduct Provisions", Supplementary Consultation Paper, 22 October 2020. [online] Available at: https://www.ea.govt.nz/assets/dms-assets/27/MDAG-supplementary-consultation-on-trading-conduct-v2.pdf **(referred to in this paper as 'our October paper' or 'the October paper')** .

[21] The objective of the Authority is to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers – s.10, Electricity Industry Act 2010.

Our brief

7. In November 2017, the Electricity Authority (Authority) asked the MDAG to review the "high standard of trading conduct" provisions in the Code and advise whether they are "adequate to promote the Authority's statutory objective, or whether changes are required to better promote outcomes consistent with workable competition".[22] These HSOTC provisions are set out in Appendix 1.

8. In brief, the current provisions were developed by the WAG and the Authority "to improve confidence in the efficiency of prices when competitive pressures in the wholesale market are weak".[23] The policy objective in MDAG's brief from the Authority is the same. As noted in our February paper[24], the central question is, how best to discipline offers for generation and instantaneous reserve[25] when competitive pressures are relatively weak?

9. The Authority's request to MDAG noted that it is a review "in light of events that have tested these provisions" and that MDAG should "take into account any findings from case studies, performance reports and compliance reports".[26]

Problems with current regime

10. The history of and rationale for the current HSOTC provisions are set out in our February paper at Part B, paragraphs 38 to 44.

11. Part C of our February paper summarised our analysis of the problems with the current HSOTC provisions as follows:

    (a) The root legal meaning of "high standard of trading conduct" does not relate to abuse of market power. Further, what it means is somewhat amorphous. (This is discussed further in paragraphs 68 to 78 of our February paper).

    (b) To the extent that coverage of pivotal situations is derived in the legal interpretation of HSOTC, the legal tests of compliance do not necessarily map across to a coherent economic efficiency framework.

    (c) If an economic efficiency framework were to be derived by the courts for HSOTC:

        (i) It would not necessarily use the assumptions and benchmarks assumed by the Authority; and

        (ii) It would not necessarily be exclusive of other non-efficiency criteria in assessing compliance.

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[22] Market Development Advisory Group work plan for 2017/18 – request to undertake Review of spot market trading conduct provisions project, letter from Carl Hansen, Chief Executive, Electricity Authority, to James Moulder, Chair, MDAG, 20 November 2017, available at https://www.ea.govt.nz/dmsdocument/22983-letter-to-mdag-2017-18-work-plan-request-to-add-trading-conduct-project.

[23] Letter from Authority to WAG Chair, 22 June 2012, WAG work plan.

[24] See our February paper at para 16.

[25] The trading conduct provisions apply to both generators and ancillary service agents in relation to generation and reserve offers. See clauses 13.5A and 13.5B of the Code.

[26] EA, Dec 2017 at 1.9.

(d) If the benchmark for HSOTC were to reflect the Authority's interpretation of its statutory objective with respect to its competition limb, which is workable competition with prices tending in the long-term toward competitive levels, such a counterfactual is not necessarily useful in assessing the efficiency of high short term prices in a pivotal situation.

(e) As with any rule, its effectiveness depends on monitoring and enforcement. In its genesis, the Authority acknowledged that "a rigorous monitoring programme" would need to be part of the HSOTC package, and the WAG noted the importance of frequency of enforcement. It could be argued the HSOTC provisions provided effective deterrence, which is reflected in requiring only three enforcement actions to date. On the other hand, it could be seen as an indication of under resourcing in compliance action.

(f) Like most conduct mechanisms, a rule requiring a "high standard of trading conduct" in pivotal situations runs counter to the underlying ability and incentives of pivotal parties to exercise market power to advance their economic interests. On a first-principles analysis, an HSOTC rule is much less likely to be effective than incentive-aligned measures. This is discussed further below.

12. Our February paper also set out at paragraphs 79 to 100 our view of problems with the 'safe harbours' provisions in the current HSOTC provisions – namely they:

(a) shelter and facilitate behaviour inconsistent with a HSOTC;

(b) are not available to some power plants;

(c) are difficult to apply in practice;

(d) are legally uncertain;

(e) are too lax for non-pivotal parties even if their offering behaviour is inefficient; and

(f) use an odd regulatory design.

13. In the light of submissions, cross-submissions and the evaluation panel process, MDAG considers that this distillation of problems with the current HSOTC provisions remains robust. Indeed, the evaluation panel process of applying the current provisions to a menu of five indicative real-world case studies only confirmed the problem analysis outlined in Part C of our February paper.

Range of options

14. Part D of our February paper outlined the spectrum of options that have been considered for addressing or mitigating the risks of weak competition in the wholesale electricity market. From a first principles perspective, we tend to agree with Prof Stephen Littlechild that it is better to focus on structure and incentives in designing remedies (new entry, enforced divestment, contracts markets and the like), rather than on conduct[27]. As we observed in our February paper[28], conduct provisions typically tend to be not well aligned to participants' incentives.

[27] Littlechild, 2001.

[28] See our February paper at para 106.

15. Our high-level view of the costs, risks and benefits of the broad options, based on available information, is set out in Figure 7 on page 40 of our February paper. Given this assessment, we focused on developing an improved behavioural measure.[29]

Initial proposal

16. Our initial proposal is set out in Part E of our February paper. It proposed the deletion of existing clauses 13.5A, 13.5B and the definition of "pivotal" in the Code, replacing those provisions with the following:

> (1) Where a **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 an **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.**
>
> (3) The purpose of this clause 13.5A is to promote offer behaviour and efficiency outcomes consistent with competitive markets, in particular so that—
>
> (a) the prices of **offers** or **reserve offers** do not exceed, for too much or by too long, 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;
>
> (b) with the effect that **offers** or **reserve offers** made by **generators** or **ancillary service agents** promote efficient:
>
> (i) consumption decisions by consumers; and
>
> (ii) production decisions by suppliers (including generators and providers of electricity services); and
>
> (iii) innovation and investment by suppliers and consumers (including the location of their investments); and
>
> (iv) risk management and risk management markets,
>
> in relation to the **point of connection** to the **grid** (including an **interruptible load group GXP**) at which the **generator** or **ancillary service agent**, as applicable, submits or revises an **offer** or a **reserve offer**, and any **node** in respect of which the **offer** or **reserve offer** may have a material influence on efficiency outcomes of the kind referred to in paragraphs (i) to (iv).

[29] Recognising the inherent limitations outlined above in relation to weak alignment of incentives for conduct rules.

Drafting note: The use of the long dash (em dash) in the above drafting ("in particular so that—") signifies that paragraphs (a) to (b) which follow are essentially one continuous sentence.

(c) Where, for the purposes of paragraph (a) "economic costs" in clause 13.5A(3)(a):

(i) When assessed in relation to short-run costs, includes the opportunity cost of fuels (including water) and scarcity rents; and

(ii) When assessed in relation to long-run costs, includes recovery of capital costs with a suitable premium for risk, as well as fixed and variable operating costs.

17. The essence of this test is to compare the offer in question to the offer that the supplier would have made in a market where no party could exercise significant market power. Absence of significant market power is a defining element of workable competition. However, as explained in our February paper, the advantage of our proposed formulation is that it cuts through some of the uncertainty around "workable competition" and sets out directly the assessment framework to be used.

18. The purpose clause (clause 3) was intended to express in a single sentence the essence of economic efficiency, which underpins 'the rule'. In short, it was intended to frame 'the rule' and calibrate its counterfactual. Among other things, the reference to economic cost was to make it clear that opportunity cost and scarcity rents are essential in the New Zealand system.

19. Our initial proposal also included a recommendation to enhance the Authority's compliance and monitoring function[30].

20. Part E of our February paper sets out in more detail the rationale for our initial proposal.

[30] See our February paper, Executive Summary at xiii and paras 67(e), 186(d), 262.

Part B: Review by stakeholders and evaluation panels

Overview of process

21. We have consulted with market participants, and tested our proposals with independent experts, extensively in this process. This has included:

    (a) two workshops with stakeholders in June-July 2019, one in Wellington, the other in Auckland;

    (b) a six-week consultation calling for submissions on our paper of February 2020;

    (c) two workshops in March 2020, one in Wellington, the other for participants based in Auckland, to engage with stakeholders on their submissions on our February 2020 paper;

    (d) a first round of bilateral meetings with individual market participants on the submissions received during the consultation in March 2020;

    (e) a second round of bilateral meetings with individual market participants held over June and July 2020 to discuss the then proposed case studies for the evaluation panels process;

    (f) the evaluation panels process in July and August 2020 (which is outlined further below);

    (g) a third round of bilateral meetings with individual market participants to discuss the findings and recommendations of the evaluation panels held over September and October 2020; and

    (h) a two-week supplementary consultation calling for submission on our paper in October 2020, which outlined proposed changes to our initial proposal in February 2020.

22. We expand on these steps briefly below. Our recommendations to the Authority have been strongly informed by views and advice we received in this process, and from leading experts in legislative drafting and law and economics.

Submissions and cross-submissions on our paper of February 2020

23. In our February paper, we asked stakeholders for written submissions on:

    (a) whether we have correctly defined the problems (regarding the potential problem of pivotal behaviour and potential problems with the current provisions)

    (b) whether we have correctly characterised the possible options to address the problems

    (c) MDAG's preferred option

    (d) whether the proposal should apply to all offers at all times, as proposed, or should be restricted to pivotal supply and, if so, whether it should apply only to net pivotal supply, and

    (e) the cost-benefit analysis.

24. Submissions and cross-submissions from industry participants spanned a range of views. A summary is set out in Appendix 2. These can be broadly grouped into two main categories:

    (a) those in favour in principle: within this group there were some differing views regarding the purpose clause, with some expressing support while others expressed concern about how it might be applied in practice; and

(b) those not in favour: among this group, the purpose clause was also a key area of concern.

25. Some submissions argued that the purpose clause (clause 3) in our initial proposal would lead to de facto price control, due to the reference to offer prices not exceeding by too much or for too long the economic costs of supply. This was certainly not the intention and we considered the risk to be relatively low. Whether this would occur would depend on how the Rulings Panel and the courts interpreted and applied clause 3.

26. Concern was also expressed that the proposal might encourage opportunistic or vexatious breach allegations.

Workshops and bilateral consultations

27. We then held two workshops in March 2020, one in Wellington, the other for participants based in Auckland, to engage with stakeholders on their submissions on our February paper.

28. This was followed by a round of bilateral meetings with individual market participants to discuss their submission.

Evaluation panels process and further bilateral consultations

29. On completion of the submission and cross-submission stages, we established two independent evaluation panels to act as proxies for the Rulings Panel or courts. Their task was to interpret and apply the existing code provisions, and our proposed code provisions, to a menu of indicative real-world case studies in an objective and rigorous manner. The purpose of this exercise was to establish on a more empirical and expert basis how the existing and proposed codes would likely be interpreted in practice, and in the process learn more of the qualitative and quantitative costs and benefits of the two alternatives.

30. The case studies were developed in consultation with all parties who made submissions, drawing on real world situations. We held a round of bilateral meetings with individual market participants in June and July 2020 to discuss the proposed case studies for the evaluation panels process.

31. Panel ABD[31] comprised:

(a) Hon Raynor Asher QC, former Judge of the Court of the Appeal

(b) Dr Alan Bollard, Chairperson of the Infrastructure Commission; and

(c) Pat Duignan, Finance and Economics Expert Lay Member of the High Court.

32. Panel HBR[32] comprised:

(a) Hon Rhys Harrison QC, former Judge of the Court of Appeal;

(b) Dr Mark Berry, former Chair of the Commerce Commission; and

(c) Iain Rennie, former State Services Commissioner.

[31] An acronym derived from the first letter of each member's surname.

[32] Ibid.

33. In addition to interpreting and applying the relevant provisions to the case studies, each panel was also invited to comment on how our proposal could be improved to better achieve the policy objective. The panels were not asked to review or arbitrate competing stakeholder submissions.

34. The two panels worked independently of each other using the same case study materials and reached similar conclusions. The panels' reports are published on the Authority's web site[33]. In summary, both panels:

    (a) considered that the current code was unsatisfactory due (among other things) to its lack of legal meaning and ambiguity;

    (b) supported the adoption of an economic-based test (as proposed by MDAG), in preference to the current code;

    (c) considered that the operative clauses in our proposal (clauses 13.5A(1) and (2)) are fundamentally sound;

    (d) thought the purpose statement (clause 3) was too complex and long, which detracted from clarity. One panel commented that the clause appeared to be trying to do too many things. Both panels considered that the purpose clause could be streamlined. One panel suggested that an explanatory note could be used within the code to convey context and framework of the operative clauses.[34]

35. Several submitters[35] thought that the evaluation panel process was very useful to ensure that the proposal is evidence-based and overall has added value to the policy process. One submitter had an opposite reaction to the panels and claimed that "MDAG seems to have placed undue weight on the use of evaluation panels relative to submissions" and "[t]he evaluation panel process was opaque and MDAG controlled the content to which panel members were exposed as well as the presentation of the evaluation panel's findings" [36].

36. We strongly refute both of the latter two claims. All feedback received from submitters was duly considered in the development of the proposal and all submitters had the opportunity to provide their feedback on the case study materials that was evaluated by the panels. In terms of the panels process, MDAG consulted with each submitter on the proposed evaluation panel process and case studies before we started the process. Throughout the process, MDAG was especially careful to ensure that panel members were not guided in any way by MDAG or the Authority in relation to how the panels interpreted or applied the two sets of provisions, or in relation to the relative merits the existing code compared to our proposal. MDAG also ensured that the two panels worked independently of each other, with the panel sessions held on separate dates and in different locations. Panel members also assured us that they did not confer privately. Each panel provided its own relatively detailed report on its findings and recommendations, and both reports were published on the Authority's web site.

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[33] *"Findings of the Evaluation Panels"*. High Standard of Trading Conduct. Market Development Advisory Group. 15 September 2020. [online] Available at: https://www.ea.govt.nz/development/work-programme/pricing-cost-allocation/review-of-spot-market-trading-conduct-provisions/development/.

[34] We subsequently consulted two members of this panel and they both preferred our recommended code change over an explanatory note alternative.

[35] Haast, Independent retailers, Mercury, MEUG and Trustpower.

[36] Meridian at page 11 of their submission on our October paper.

Further bilateral consultation

37. In September and October 2020, we held a third round of bilateral meetings with individual market participants to discuss the panels' findings and recommendations.

Developed revised proposal

38. The quality of the learning and insight gained in the evaluation panel process was considerable, which included a set of independent expert views on the comparative costs and benefits of the proposed and existing provisions from an applied perspective, which has strongly informed our revised proposal. We also carefully considered the evaluation panels' findings and insights relative to the issues raised by stakeholders in submissions and cross-submissions.

39. We concluded that, in relation to our initial proposal in our February paper:

    (a) The 'rule' (in the two operative clauses) is sound and should be retained;

    (b) The purpose clause is problematic – there is an apparent risk that it may not work as intended. Both panels thought the purpose statement was too complex and long, which detracted from clarity and would increase litigation risk. One panel commented that the clause appeared to be trying to do too many things; and

    (c) As recommended by the Panels, we should seek to achieve the aim of the purpose clause more effectively, either in a re-drafted (streamlined) clause or in an explanatory note (or a combination of the two), whichever is optimal from a technical legal drafting perspective.

40. We took advice from leading specialists in legislative drafting and tested a range of formulations. We also consulted with Hon Rhys Harrison QC and Iain Rennie, who were panel members, on their view of alternative formulations

41. We proposed only minor changes to 'the rule' as tracked below:

> "Where a **generator** submits or revises an **offer** ~~for a point of connection to the grid~~, that **offer** must be consistent with the **offer**~~s~~ that the **generator**, acting rationally, would have made if ~~where~~ no **generator** could exercise significant market power ~~in relation to that~~ at the **point of connection** to the **grid** ~~for that~~ and in the **trading period** to which the **offer** relates"
>
> *[Same rule for reserve offers by ancillary service agents]*

42. These were explained briefly as follows:

    (a) "the generator would have made" is changed to "the generator, acting rationally, would have made" – as highlighted in blue. This is to clarify that it is not the subjective view of the generator, but rather an objective view based on the generator behaving in an economically rational manner;

    (b) "where" is changed to "if" – as highlighted in yellow. "If" better conveys that the clause requires a comparison of an 'actual' to a 'what if'. (Sometimes such a 'what if' case is referred to as a counterfactual); and

(c) tweaks to improve the plain English flow without changing the meaning (e.g. deleting a repetition of "point of connection to the grid"; changing "offers" to "the offer" to link with "an offer" in the first line; and replacing "in relation to that" with "to which the offer relates" and minor associated tweaks).

43. In relation to the purpose clause, we proposed to:

(a) **delete** the purpose clause and **replace** it with a simplified preamble clause that leads into the 'rule', and

(b) **add** a new clause 3 with an explanation of when market power become "significant".

44. Our revised proposal put out for consultation in October 2020 was as follows (with the provisions replacing clause 3 in our initial proposal highlighted in **red**):

(1) In the **spot market –**

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

(b) however, there may be locations where, or periods when, one or more generators, or ancillary service agents, as the case may be, has significant market power.

(2) Accordingly –

(a) where a **generator** submits or revises an **offer**, that offer must be consistent with the **offer** that the **generator**, acting rationally, would have made if no **generator** could exercise significant market power at the **point of connection** to the **grid** and in the trading period to which the **offer** relates;

[same for reserve offers by ancillary service agents]

(3) For the purposes of this clause –

(a) market power becomes significant when its exercise would have a net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency;

(b) "spot market" has the same meaning as **wholesale market** except that it excludes the hedge market for **electricity** (including the market for **FTRs).**

45. We explained in our October paper that we consider this better achieves the drafting goal of framing:

(a) the 'rule' in the context of the competitive disciplines that generally apply in the market [clause (1)(a)];

(b) the problem that the 'rule' is addressing, namely clause (1)(b); and

(c) when market power becomes significant [clause (3)(a)].

46. We also noted that in relation to the passive construction in clause (1)(a), "it is expected" refers to the expectation of the spot market.

Submissions on revised proposal

47. In our October paper, we sought feedback from market participants on:

(a) whether the proposed 'rule' [clause 2] is better than the existing provision requirement for "conduct in relation to offers and reserve offers is consistent with a high standard of trading conduct";

(b) whether the economic efficiency framework underpinning the proposed 'rule' is better than the existing HSOTC framework;

(c) if the new preamble [clause 1] is effective in conveying succinctly the intended framework and purpose of the 'rule' [clause 2];

(d) if parties agree with clause 3(a), which states when market power becomes significant; and

(e) whether parties overall support the revised proposed code change in preference to the existing HSOTC provisions.

48. A summary of the submissions is provided in Appendix 3. Contact, Nova, Haast, Electric Kiwi, and all the other independent retailers agree that, overall, our proposed rule is better than the existing HSOTC provisions. The other submitters seem to consider that our proposal is an improvement on the status quo but raised questions or expressed concerns of various kinds, which we comment on below.

Part C: Final proposal

Conclusion

50. As with all previous rounds of consultation, we have carefully considered the views of submitters in their submissions in response to our October paper. We have concluded that:

    (a) The 'rule' in clause 2 remains sound and should be retained; and

    (b) The new preamble provision (clause 1) and supporting provision (clause 3), which replace the purpose clause (clause 3) in our initial proposal, are also sound and likely to be effective in achieving the intended framing of the 'rule' in clause 2.

51. Our final code change proposal is set out in full and without tracked changes at the front of this paper on page 8.

52. We consider that the conclusion set out in our October paper holds: this proposed code change is considerably better than the existing HSOTC provisions and should be put in place as an improved mechanism for mitigating the risks of significant market power.

53. Achieving the Authority's policy objective in this matter will depend crucially on improved monitoring and enforcement. We therefore also recommend strongly that the Authority:

    (a) undertake more frequent and rigorous monitoring of participants' behaviour in periods or locations of weak competition. Deterrence includes the Authority sending more frequent 'please explain' letters when questionable behaviour is observed;

    (b) better resource the Authority's monitoring, enforcement and compliance arms; and

    (c) engage with the Ministry of Business, Innovation and Employment (MBIE), as the Ministry responsible for administering the Electricity Industry Act 2010, to consider proposing raising the maximum penalty applicable for breaches of the trading conduct provisions.

54. We comment below on various elements of the rationale for these recommendations. We also comment on particular matters raised in submissions.

High prices in periods of scarcity

55. As outlined in our October paper, our proposal would not change the proper functioning of a competitive spot market in increasing the clearing price to high levels when supply is genuinely short relative to demand. In economic terms, opportunity costs and scarcity rents are both typically elevated.

56. In New Zealand's energy-only, hydro-dominated system, opportunity costs of hydro fuel (water) and scarcity rents are relatively significant and highly variable. In economic efficiency terms, it is important that both are fully reflected in wholesale prices. For this to occur, it does not rely on the exercise of significant market power – it occurs when the market is effectively competitive. Our proposal does not change this.

57. On a more technical level, in a competitive market with free entry, scarcity rents will on average equal the cost of new capacity over time[37]. The net present value of efficient short run marginal costs (SRMCs) should equal the long run marginal cost (LRMC) over time, which includes the risk adjusted capital cost of producing an additional unit of electricity from the next lowest cost source over the longer run. Our proposal does not change this.

58. Obtaining scarcity rents (which, as noted above, cumulatively equal the cost of new capacity over time) should not rely on the exercise of significant market power on a transient basis. Our proposal does not change this[38].

"Significant market power"

59. We consider that our proposal to use "significant market power" as the yardstick in the 'rule' remains robust. Our rationale is outlined in our February paper (at paragraphs 119-123).

60. To recap, market power is "the ability to affect the market price even a little and even for a few minutes" [39]. As Prof George Yarrow and Dr Chris Decker point out[40], these definitions imply that market power is almost ubiquitous – modest levels of price influence are generally beneficial, hence their ubiquity. Yarrow and Decker also note that price influence is central to the discovery processes that drive economic adaptation and progress, and that a market in which individual participants each have only limited price influence would typically be described as "competitive", not as a market characterised by low levels of market power. What matters is the degree to which prices can be influenced by one party or group of co-ordinating parties, or the degree to which prices can be set above some relevant measure of economic costs.

61. Yarrow and Decker observe that, for these reasons, the term market power in competition law and public policy generally appears with a qualifying adjective such as 'significant' or 'substantial' so as to focus on the issue of interest – the degree of such power[41].

62. As outlined in our February paper[42] we are not using the term 'substantial' as found under section 36 of the Commerce Act[43] on the prohibition of taking advantage of market power. There are two key reasons for this:

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[37] Bushnell, J, Flagg, M, Mansur, E, Electricity capacity markets at a crossroads, DEEP WP 017, UC Davis Energy Economics Program, page 11 - https://hepg.hks.harvard.edu/files/hepg/files/wp278updated.pdf.

[38] For the avoidance of doubt, our recommended proposal is not intended to allow the transient exercise of significant market power – this is explained further in our February paper at Annex 2, paras 215 and 216.

[39] "Power System Economics," Dr Steven Stoft, at p 318, which adds: "This definition may sound harsh, but it is not. It is simply a definition without punitive implications" – cited in the Commerce Commission, May 2009 at 242.

[40] Yarrow, G. and Decker, C., 2014. *Bidding In Energy-Only Wholesale Electricity Markets*. p.21. [online] Available at: https://www.aemc.gov.au/sites/default/files/content/c196404a-e850-46bd-8ae2-41600f8454bb/Professor-George-Yarrow-and-Dr-Chris-Decker-%28RPI%29-Bidding-in-energy-only-wholesale-electricity-markets-Final-report.PDF.

[41] The source for this paragraph is Yarrow and Decker, Nov 2014, at page 21. Note footnote 14, which cites Dr Steven Stoft's definition of market power – the same reference used by the Commerce Commission in its definition of market power referred to above.

[42] See our February paper at para 16at para 119.

[43] s.36 of the Commerce Act 1986.

(a) First, "substantial degree of power in the market" in section 36 is typically used to refer to the existence of market power over much longer periods than the short run occurrences that can cause concern in electricity spot market. In this market, the exercise of market power manifests in high price spikes that are transitory (typically over a few trading periods) in nature.

(b) Second, section 36 cases involve showing that a party acted with a clear anti-competitive purpose beyond simply raising prices.[44] Anti-competitive purpose is not a necessary criterion in assessing whether an offer is efficient and so anti-competitive purpose is not required under our proposed test.

63. The test proposed by Yarrow and Decker for when market power becomes 'significant' is when the potential for inefficiency or harm is sufficiently high to warrant incurring the costs of intervening.[45] The notion of net adverse impact in our proposed clause (3)(a) draws on this concept that: "market power becomes significant when its exercise would have a net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency". As noted below, economic efficiency is now well established as a frame of reference in the courts and the Commerce Commission. (The term "net" is further discussed in paragraphs 99 - 100 below).

64. One submitter[46] recommended tweaking the definition of when market power becomes significant to link it more closely to all three limbs of the Authority's statutory objective. MDAG considers that the economic efficiency test links strongly to the competition limb of the statutory objective for the long-term benefits to consumers. The same submitter also proposed that the test of when market power becomes significant should include when it would "otherwise cause harm to consumers". In effect, this is proposing that the test should include distributional or wealth transfer considerations, which the Authority has excluded in its interpretation of its statutory objective.[47]

Economic efficiency

65. Economic efficiency is well understood in competition law and economics, and well embedded in New Zealand's legal jurisprudence. For example, in 2016, the Court of Appeal in *Godfrey Hirst NZ Limited vs Commerce Commission*[48] cited with approval its 1988 decision in *Tru Tone Limited v Festival Records Retail Marketing Limited*[49]*:*

> "[the Commerce Act] is based on the premise that society's resources are best allocated in a competitive market where rivalry between firms ensures maximum efficiency in the use of resources".

66. At paragraph [16], the Court of Appeal further noted its earlier decision in *Tru Tone Ltd*:

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[44] As noted in WAG, May 2013 at 4.1.1.

[45] Measuring both potential harm/inefficiency and costs of intervention in net present value terms – see Yarrow and Decker, Nov 2014, at page 21, paras 4 and 5.

[46] Independent retailers' submission at page 1 of our October paper.

[47] Electricity Authority, *Interpretation of Statutory Objective",* 14 February 2011 at 2.2.1, A.6, A.8-A.10, A.24-25. A.31.

[48] Godfrey Hirst NZ Limited vs Commerce Commission [2016] NZCA 560 [30 November 2016]. [online] Available at: https://comcom.govt.nz/__data/assets/pdf_file/0036/69399/Godfrey-Hirst-NZ-Ltd-v-Commerce-Commission-Court-of-Appeal-Judgment-30-November-2016.PDF.

[49] Tru Tone Ltd v Festival Records Retail Marketing Ltd [1988] 2 NZLR 352 (CA). See further discussion in NZME v Commerce Commission (2018) 15 TCLR 201 at [74].

> "[The Court of Appeal]…does not view the promotion of competition as an end in itself but, rather, as a vehicle for fostering overall economic efficiency."

67. At paragraph [19], the Court of Appeal cited with approval the High Court's decision in *AMPS-A HC*[50], which among other things held that efficiency has three dimensions:

> "We bear in mind that efficiency has three dimensions commonly referred to as allocative efficiency, production efficiency and dynamic efficiency".

68. At paragraph [20], the Court of Appeal also noted that:

> "Efficiency became an established pillar of New Zealand's competition law and policy".

69. In 2018, the Court of Appeal further observed in *NZME v Commerce Commission*[51] that:

> "Efficiency is not confined to the efficient economy-wide allocation of resources; it includes productive and dynamic efficiency in relevant markets.

70. This definition of efficiency was established in the context of the Commerce Act, however the relevant language is closely analogous to the use and context of "efficiency" in the Electricity Authority's statutory purpose.

Desire for certainty

71. Several parties have called for a rule that provides a high level of certainty for wholesale traders in their day-to-day trading activities. We understand this motivation.

72. In reality, however, the boundaries of the existing HSOTC provisions are far from certain. Moreover, while the 'safe harbour' provisions may appear to provide a lower risk refuge, they are in fact[52] riddled with uncertainty, and can give rise to perverse and inefficient outcomes. This was strongly apparent in the evaluation panels' analysis of various case studies.

73. In our view, our recommended provisions are considerably less uncertain than the existing HSOTC provisions. Our proposal locates the core test within a coherent framework, with established concepts and boundaries, that is both more certain (providing greater steerage) to market participants, and much more aligned with the requirements of the Code[53] than the existing HSOTC provisions.

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[50] Telecom Corporation of New Zealand Ltd v Commerce Commission (1991) 4 TCLR 473 (HC) [AMPS-A HC].

[51] NZME v Commerce Commission (2018) 15 TCLR 201 at [74].

[52] See our February paper at paras 79-100.

[53] Section 31 of the Electricity Industry Act 2010, "(1) The Code may contain any provisions that are consistent with the objective of the Authority and are necessary or desirable to promote any or all of the following: (a) competition in the electricity industry" – see the Electricity Authority's *"Interpretation of the Authority's Statutory Objective"*, 14 February 2011 at paras A.20 – 31. We consider that our proposal also better aligns with section 32(1)(b) and (c) in that an optimal level of reliability of supply and efficient operation of the electricity industry are necessary outcomes of economic efficiency

74. The problem of uncertainty is not with our proposed rule; rather, it arises from the underlying uncertainty in gauging if and when competition has reached a level of weakness that it causes outcomes adverse to the market as a whole and how it impacts on economic efficiency. This boundary between sufficient and insufficient competition is inescapably a matter of judgement, not a mechanical formula.

75. If in doubt, compliance with our recommended rule is available by market participants acting on the assumption that they face vigorous competition.

76. A rough indicator of economic efficiency in relation to offers in the spot market is that they should signal changes in physical supply and demand conditions at the locations and in the periods to which they relate.

77. A rough indicator of market power is the degree to which an offeror can raise its offer price without facing the risk of reduced sale volumes due to the response of rival suppliers or customers.

78. Indicators of this kind could, in due course, be issued as guidelines by the Authority. It is important to note, however, that our recommended code change does not require guidelines in order to be put in place. Our proposed provisions are self-contained and fit for purpose on their own terms.

79. Market participants can reasonably be expected to develop internal protocols guided by their advisers on how they intend to approach and apply the proposed provisions as a matter of internal corporate policy.

80. Some submitters have called for guidelines with specific examples of when offers may be in breach of the proposed rule. We understand the desire for that sort of 'black and white' manual, however we have concluded after careful consideration that it is not practical. It is also important to keep in mind that our proposed rule is based on a well-established framework (of effective competition causing economic efficiency), not a series of discrete prescriptions for different fact situations. Trying to create a manual covering all likely fact situations would give rise to an almost infinite number of cases and permutations without necessarily answering the next fact situation that a trader may be dealing with. What counts is understanding and applying the framework, which market participants can reasonably be expected to set out in internal corporate policies with guidance from their advisers. Each market participant will need to apply the rule to its particular situation and mix of activities. Maintaining an internal capability of explaining changes in offers is also important.

81. The Authority can assist by ensuring that market participants can readily access precedents established by the Rulings Panel or the courts, or indeed by the Authority in deciding whether or not to bring a case for an alleged breach of the proposed rule following a "please explain" request.

"Acting rationally"

82. As explained briefly in our October paper, we added the words "acting rationally" to the proposed rule to clarify that it is not the subjective view of the generator, but rather an objective view based on the generator behaving in an economically rational manner.

83. Meridian argues[54] that "it should go without saying that generators or ancillary service agents in any counterfactual test are expected to behave in a rational manner". This is not the case. Without the words "acting rationally", it would be open for a generator to argue (and for a court to interpret the rule as saying), that the test is the generator's subjective view on what it would do in the counterfactual.

84. As pointed out by another submitter[55], adding "acting rationally" corresponds with the qualification inferred by the courts in the counterfactual test under section 36 of the Commerce Act[56], in relation to which the Supreme Court has observed[57]:

> "The necessary assessment must be undertaken on the basis that the otherwise dominant firm will act in a commercially **rational** way in the hypothetically competitive market. The assessment is also likely to involve an examination of the factors that might constrain the firm from acting in the same way in the hypothetically competitive market. The Court is involved in making what is essentially a commercial judgment. That judgment must be made objectively and should be informed by all those factors that would influence **rational business people** in the hypothetical circumstances which the inquiry envisages" (emphasis added)

Risk of opportunistic legal challenge

85. Some submitters raised concerns in relation to the initial proposal that it could allow opportunistic challenge to a wide range of offers, and so it should not apply to all offers. To the extent this may have been a real issue, we consider that the changes we have made mitigate such a risk substantially.

86. In particular, our recommended preamble makes it clear (in clause 1(b)) that the rule is concerned with situations where one or more generators (or ancillary service agents, as the case may be) has significant market power. Further, clause 3(a) provides a threshold for when market power becomes significant (which requires a net adverse impact on economic efficiency).

87. Opportunistic or vexatious claims could make no progress unless they reached those thresholds, and it is for the Authority as the prosecuting body to decide whether it takes a case to the Rulings Panel.

88. One submitter[58] suggested imposing an application fee, or perhaps a reimbursement of costs, payable in advance should a claim be deemed vexatious, which could be reimbursed should the claim be found in a hearing to have merit. We do not consider this to be necessary given the requirements of the rule and the Authority's role in deciding whether to take a case to the Rulings Panel.

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[54] Meridian at pages 5 and 6 of its submission on our October paper.

[55] Nova's submission on our October paper.

[56] Which prohibits persons from taking advantage of market power in the context of preventing or eliminating market access or preventing or deterring competition.

[57] *Commerce Commission v Telecom,* [2010] NZSC 111 at [35] (see also [30-36]). See also Turners & Growers v Zespri CIV 2009-404-004392 at [340-344].

[58] Mercury's submission on our October paper.

Why not only apply it to pivotal parties?

89. Some submissions[59] suggested that our initial proposal should apply only to pivotal suppliers. We understand the intent but do not support such an approach for a range of reasons. Among other things, the definition of "pivotal" does not map across to "significant market power", which is the central yardstick in our proposed rule. Merging the two concepts within the rule would only create incoherence. We consider that "significant market power" linking to economic efficiency is a better framework.

90. We also observe that:

    (a) restricting the scope to particular circumstances or to specific types of market participants would reduce the efficiency gains and the long-term benefits to consumers that would otherwise be obtained. In particular, collusive actions (whether tacit or explicit) from multiple parties can be as harmful to economic efficiency as abuse of market power by a single party[60]. The rule would therefore potentially capture actions such as:

        (i) 'coat tailing', where a party or parties follow the lead of others to raise their offers but without losing volume; and
        (ii) withdrawal of volume by multiple parties[61]; and

    (b) requiring decision-makers to focus on efficiency impacts when determining whether the "significant market power" threshold is met should reduce the risk of unintended consequences.

91. Also, as several parties have observed[62], it is often not clear in practice whether a party is gross or net pivotal *ex-ante*.

Market definition

92. In its submission on our February paper, Meridian noted that market power can only be assessed in a properly defined market. It stated that the proper definition would depend on the facts, and could conceivably range from a single node and trading period through to the national market considered over multiple trading periods.

93. However, Meridian was concerned that the wording in our February proposal might be construed as always defining a market to be a single node and trading period because it referred to an assessment of market power "in relation to that point of connection to the grid for that trading period". In its submission on our October paper, Meridian proposed that the new rule should set the market definition as "in the spot market" (as a whole).

94. In reality, the market definition will vary according to each situation, taking account of factors such as the scope for substitution on the demand-side (e.g. by deferring usage) and the supply-side (e.g. extent to which other suppliers can respond).

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[59] For example Contact Energy, Genesis Energy and Mercury on our February paper.

[60] It is for this reason that the Commerce Act has provisions applying to both abuse of market power by a single party (section 36) and multiple parties (sections 27-30).

[61] Which is similar to the existing safe harbour clause 13.5B(1)(a), which requires each party to offer all available capacity.

[62] For example Meridian Energy on our February paper.

95. Meridian's proposed market definition of "in the spot market" would imply the entire geographic extent of the spot market is always the frame of reference, which is clearly not correct, as acknowledged by Meridian in its submission on our February paper.

96. We consider that the concern raised by Meridian is properly addressed by the following aspects of our proposal:

    (a) Clauses 2(a) and 2(b) of the proposed rule refer to a test of whether a supplier "could exercise significant market power **at** the point of connection to the grid and **in** the trading period to which the offer relates" (emphasis added); and

    (b) Clause 3(a) of the proposed rule defines when market power becomes significant.

97. The references in clauses 2(a) and 2(b) do not use the "in relation to" language which might be construed as implicitly defining a market. Instead, the clauses use the physical reference terms needed to identify a particular offer (a location and time).

98. More importantly, the inclusion of a definition of "significant" in clause 3(a) should remove any doubt about an overly narrow (or wide) definition being applied to either the location or time period when assessing market power. It achieves this by making it clear that market power becomes significant when its exercise would have net adverse efficiency impacts.

99. Meridian has commented that it is not clear what the term "net" in the definition of significant market power is referring to. Meridian also claims that the attempt to define significant market power is "overly broad as it has no countervailing costs of intervention threshold to overcome" and "MDAG seems to be saying with this proposed clause that all market power is significant because exercising market power even a little would have an adverse impact."[63]

100. We are comfortable that the efficiency measures in the proposal sufficiently inform the definition of net adverse impact:

> "market power becomes significant when its exercise would have a net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency".

101. The reference to "net" requires an adjudicator to consider all economic efficiency effects (negative and positive) which arise from an alleged exercise of market power, rather than just the harmful effects. The word "net" is not further defined because it is not possible to know in advance the kind of effects that might be raised in this category. However, these could include matters such as incentives to invest in future capacity, to properly manage risks, and to innovate by providing new products or services.

102. Accordingly, if there are positive efficiency impacts which outweigh the negative effects arising from the exercise of market power, then the 'significant' threshold will not be reached and no breach of the proposed rule would have occurred. On this basis, it is not correct to say that the costs of an intervention (i.e. breach finding) are overlooked. Nor is it correct that all market power is significant.

[63] Meridian submission on our October paper at page 8.

Risk of *de facto* price control

103. Some parties interpreted our initial proposal as amounting to *de facto* price control. This view seems to have arisen from an overly simplified or out-of-context reading of clause 3(a) in our initial proposal, which referred to offer prices not exceeding "by too much or for too long" their associated economic costs, with our initial clause 3(c) setting out a definition of economic costs.

104. This was neither the policy intention nor a likely outcome of how the courts would have applied the relevant provisions.

105. However, based on the evaluation panel process, MDAG discerned a risk that parties could read clause 3(a) of the purpose clause in our initial proposal as an invitation for the courts to use some sort of cost-based mechanistic comparison of offer prices and costs as the yardstick for determining whether the operative clause had been breached. As noted above, such an outcome was (and is) not intended.

106. On a related note, some parties[64] expressed concern that the meaning of "by too much and for too long" was too uncertain. This view was shared by some members of the evaluation panels and this was another reason for deleting those words from our revised and now recommended proposal.

Why not "workable competition"

107. As outlined in our February paper[65], we consider that "significant market power" as the yardstick for our rule, rather than "workable competition", cuts through various problems that would arise if we used "workable competition".

108. If we were to compare an offer in question with the offer that the supplier would have made in a market with "workable competition" –

    (a) A supplier would be able to argue that its offer under this counterfactual would be the same (or close to) the offer actually made because workable competition accommodates passing periods of weak or very limited competition and the supplier would cite other apparently plausible reasons for its high offer.

    (b) It would also be argued that price efficiency under workable competition is gauged by reference to the tendency of spot prices over the longer term relative to LRMC, not by short term prices in isolation, which would therefore support the supplier arguing that the trend of its offers over the longer term is consistent with LRMC despite its apparent transient exercise of market power.

    (c) Further and more generally, as Bell Gully[66] has observed, there remains real uncertainty about the meaning of "workable competition".[67] Our aim is to bypass and where possible narrow much of this uncertainty by expressing our proposed test in more direct terms.

109. For these reasons, we have not used the expression "workable competition" as our benchmark.

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[64] For example Contact Energy on our February paper.

[65] At paras 142-144.

[66] Bell Gully is a law firm that is contracted from time-to-time by the Authority to provide it with expert legal advice, as required.

[67] [online] Available at: www.adls.org.nz/for-the-profession/news-and-opinion/2014/2/28/working-with-workable-competition/.

Preamble clause – "it is expected"

110. In relation to clause 1(a) of our proposal, Meridian argues that the words "it is expected" should be deleted. They claim that "the framing of these observations is slightly awkward…It is not clear who has the expectation and it does not seem appropriate for the Code itself to have expectations – it is a rule book not an animate entity"[68].

111. We do not favour this approach. Deleting "it is expected" would make an important change to the meaning of clause 1(a) in that the statement that follows it would become like an assertion of fact – namely that "offers and reserve offers will generally be subject to competitive disciplines such that no party has significant market power". It is more the case that this is the intention or expectation underlying the design of the market. Contrary to Meridian's claim, the existence of an expectation does not depend on it coming from an animate entity. The design of the spot market is founded on an expectation of effective competition.[69]

Enhance monitoring and enforcement functions of the Authority

112. A key tenet to the effectiveness of any rule or law is the achievement of deterrence. Effective deterrence is achieved through the credible threat of enforcement of that rule or law. That credibility is principally derived from the actual prosecution of breaches and the subsequent application of sanctions against those found to be in breach.

113. Further, both specific and general deterrence can be enhanced by the publication of any compliance action that is undertaken (including cases that have been considered but not progressed) and of enforcement outcomes. This will help educate other market participants about the rule of law and may also highlight reputational damage as a second tier sanction against those found in breach.

114. Deterrence is also achieved by signalling the threat of incurring high penalties for breaches of trading conduct rules.

115. For example, in 2020, EU national regulatory authorities (NRAs) issued €42.5 million ($75.7 million)[70] in fines to various energy companies for breaching Article 5[71] of the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT)[72]. From 2015 to date (2020), EU NRAs have issued a total of €76.5 million ($136.2 million) in fines for REMIT breaches.

116. In March 2020, Ofgem issued a fine of £37.2 million ($72.5 million)[73] to InterGen after it sent misleading signals to the National Grid Electricity System Operator about the energy it could supply in the winter of 2016 and which resulted in InterGen making substantial profits.

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[68] Meridian submission on October paper at page 3.

[69] The features of New Zealand's spot market design are summarised in our February paper at page 90, paras 311-314. In the relatively early stages of the market's formation, Prof Bill Hogan observed that "the New Zealand model for real-time operations is aligned with the best international practice for a competitive electricity market."

[70] Acer.europa.eu. 2020. Overview of sanction decisions. [online] Available at: http://www.acer.europa.eu/en/remit/Pages/Overview-of-the-sanction-decisions.aspx.

[71] Article 5 prohibits any engagement in, or attempt to engage in, market manipulation on wholesale energy markets.

[72] Regulation (EU) No 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency.

[73] The fine initially amounted to £47.8 million ($93.2 million) but was reduced after settlement discount on the penalty levied.

117. The evaluation panels independently recommended that the Authority prioritise monitoring and enforcement. The evaluation panels pointed out that any rule that seeks to prevent undesirable trading conduct needs to be supported by strong deterrence signals. These signals do not need to be extensive reviews or invasive investigations and softer approaches would have a similar effect e.g. the Authority sending more frequent 'please explain' notifications when questionable behaviour is noticed.

118. We concur with the evaluation panels and recommend that the Authority undertake more frequent and more rigorous monitoring of participants' behaviour, particularly when competition is weak or absent. We also recommend that the Authority better resources its monitoring, enforcement and compliance arms and to engage with the MBIE to consider proposing raising the maximum penalty applicable for breaches of the trading conduct provisions.

Part D: Cost-benefit analysis and other matters

Cost-benefit analysis

119. Our February paper assessed the costs and benefits of the proposed Code amendment on a mainly qualitative basis (reproduced below in Table 1). It concluded that the proposal would likely yield net benefits relative to the status quo.

120. That paper also included an illustrative quantitative analysis of a local pivotal supplier situation. For this hypothetical situation and based on plausible assumptions about local demand and prices, the present value benefit was estimated to be up to $7.6m (excluding dynamic efficiency benefits). This was for a single local pivotal supplier situation, and the total benefits from the Code amendment proposal were expected to be much greater. The illustrative local pivotal supplier example provided assurance that the qualitative concerns about trading conduct were credible, and that the overall efficiency effects at stake were of sufficient magnitude to be material.

121. Some submissions on our February and October papers thought the qualitative benefits had been over-stated because there was no substantive efficiency problem to address, and/or considered the costs had been omitted or under-valued.[74] Some submitters[75] stated that a detailed quantitative assessment was required. In contrast, some other submissions[76] considered that the qualitative analysis understated the benefits.

122. Dealing first with the issue of whether there is a problem to address, we make the following observations:

    (a) There is clear evidence that large generators are frequently gross pivotal across wide areas of the spot market.[77] For example, one or more suppliers was gross pivotal in the North Island in 42% of trading periods in 2018, and in the South Island the equivalent metric was 93% of trading periods.[78] While gross pivotal suppliers may not have a short-run incentive to raise spot prices due to their contract position, they will nevertheless have a longer term incentive to raise spot prices to increase returns from future hedge contract and/or retail sales. MDAG's February paper also showed that local pivotal supplier situations have occurred in recent times and are likely to continue to arise.

    (b) Analysis in our February paper showed that, depending upon supplier behaviour, adverse efficiency impacts could plausibly reach millions of dollars in present value terms for a single local pivotal supplier situation. The paper also noted that wider pivotal supplier situations can occur and could give rise to even larger costs – depending upon the behaviour of suppliers among other factors.

[74] For example Contact Energy and Mercury on our February paper.

[75] For example Genesis and the Major Electricity Users Group on our February paper.

[76] For example Haast and Electric Kiwi on our February paper.

[77] A participant is gross pivotal in a trading period if demand cannot be satisfied without some supply from that party.

[78] Our February paper at Figure 2.

(c) The existing HSOTC provisions are intended to act as a check on the abuse of market power. However, the provisions lack any clear meaning. This was underlined by experience with the panels. Indeed, one of the panels described the existing provision as a "broken rule". This lack of clarity means that consumers can have no confidence that abuses of market power will be checked by the Code, and suppliers can have no assurance that reasonable behaviour will be immune from regulatory sanction. Even among suppliers, there is some recognition that the existing HSOTC arrangements are problematic. For example, Genesis stated "there are occasions where generators have the ability to exercise unfettered market power" and that "reform is justified".[79] Meridian stated that it judged "the current HSOTC provisions to be unworkable". [80]

123. In our view, there is clear evidence that current arrangements are not satisfactory, and that reform is warranted.

124. We now turn to the question of whether a detailed quantitative cost-benefit analysis is required. At the outset, we note our strong preference is to undertake a quantitative analysis if sufficient base information is available. However, we remain of the view that a detailed quantitative analysis would not be informative in this instance. The key reason for this view is that analysis of the existing and proposed rules is inherently subjective because it involves judgments about participants' future behaviour. There is simply no reliable evidence-based quantified data on which to base those assumptions for the purposes of a fully quantified CBA. For example, the analysis would need to make assumptions about how the existing rule will be interpreted by the Rulings Panel or courts, and how participants will behave in light of that interpretation[81]. As discussed in paragraph 34, the evaluation panel process showed there is considerable uncertainty about how the existing rule would be interpreted by an adjudicatory body in practice. This makes it even harder to predict participant behaviour in the level of detail needed for quantitative analysis. In our view, a putatively quantitative analysis would simply 'play back' the behavioural assumptions adopted for the analysis, but in a way that is less transparent and open to scrutiny than in a qualitative analysis.

125. Our approach has therefore been to do a qualitative CBA, informed by the evidence produced from the evaluation panels process, together with quantitative sensitivity analysis in relation to a selection of actual examples of local pivotal market power. We consider this to be a relatively robust and transparent approach to assessing costs and benefits in relation to our proposal.

126. We also note that the Authority is undertaking several associated projects e.g. new market making arrangements and enhanced wholesale market information disclosure. To decouple their future impact from those of the new trading conduct rule would be very complex and subject to numerous assumptions.

[79] Genesis submission on our February paper at page 1.

[80] Meridian submission on our February paper at page 1.

[81] This includes the degree to which parties would change their offers relative to the offers they would have made (i) absent any rule compared to (ii) with the existing rule and (iii) without the proposed rule; and (iv) as between (ii) and (iii). As noted in our February paper at para 281, footnote 236, quantifying the benefits would also require predicting the likely frequency and duration of these future pivotal supplier situations (as well as the quantity of load affected). While these predictions can be based on what has happened in the past and what we know about the future, these predictions would also add to the uncertainty around the benefit estimation.

127. Another concern raised by some submitters was that certain costs of the proposed change had been overlooked or under-valued. Meridian in its recent submission said the proposal may deter efficient behaviour and this cost has not been considered. Meridian stated "MDAG has, in effect, asserted that its proposal can be introduced without deterring any efficient behaviour [..] For MDAG's claim to be true, investigations by the Authority and decisions by the Rulings Panel would need to always result in more efficient market prices than would result from price discovery in the market, and all generators would need to be confident *ex ante* how the rules would be applied in any given situation so that they could act accordingly."[82]

128. Meridian's critique is misplaced. We are not claiming that the proposal will have no indirect costs, but we see no reason to expect a rise in such costs relative to a situation where the existing rule is retained. We take this view because the operative provision in the current HSOTC rule has no clear meaning, whereas the proposed rule is based on conventional economic principles. Meridian's critique implicitly assumes that any enforcement action under the current rule will "always result in more efficient prices" and that at present all generators are "confident *ex ante* how the rules would be applied". Neither of these conditions seems likely to hold. Indeed, Meridian's own submission on the February paper described the existing rule as "too vague to be useful or easily understood by participants in terms of drawing a line between conduct that is and is not acceptable".[83]

129. Trustpower queried whether the proposed rule might have costs or risks such as "removing market participants' ability to use their offer prices to hedge transmission risks, recovering a margin for operating at times of transmission congestion [and] creating incentives for set and forget offers", which are not covered in the cost-benefit analysis.[84]

130. In our view, situation-specific information would be needed to comment on the merits of the conduct cited by Trustpower, and to determine how each case would be viewed under the proposed rule. Having said that, we note the proposed rule requires an assessment of whether alleged misconduct is giving rise to a net adverse impact on economic efficiency. Accordingly, if a breach was alleged, the defendant would have a robust defence if it could show that the conduct had efficiency benefits (including dynamic efficiency) which exceeded any costs.

131. Some submissions queried whether compliance costs might increase under the proposed rule and asked if this had been accounted for in the cost-benefit analysis.[85] In part, this concern seemed to stem from a view that the proposed rule might encourage opportunistic or vexatious breach allegations, and therefore result in higher legal and associated costs. For the reasons set out in paragraphs 86 - 87, we consider that the changes made to the revised proposal mitigate this risk substantially. More generally, we have not received any information through the submission process which would substantiate an ongoing step-up in compliance costs relative to continuation of the present HSOTC provisions. As explained in paragraphs 112 - 118, we recommend that the Authority enhance its compliance and monitoring functions, but this would also have been necessary under the status quo.

132. Overall, for the reasons noted above, we do not consider that material cost items have been omitted from the qualitative cost-benefit analysis.

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[82] Meridian submission on our October paper at page 10.

[83] Meridian submission on our February paper at page 3.

[84] Trustpower submission on our February paper at page 2.

[85] For example Contact's submission on our February paper at page 4 and Trustpower's submission on our October paper at page 2.

133. Having decided to retain the qualitative approach (as noted above), we have considered whether any information from submissions, or other work undertaken since February 2020, cause us to revise aspects of our assessment. We have also considered whether the changes to the Code amendment proposal itself (discussed in paragraphs 38 - 46) lead us to make any revisions.

134. The results of this re-evaluation are set out in Table 1, which follows the same format as the qualitative evaluation in our February paper.

Table 1: Evaluation of costs and benefits

	Status quo (from February 2020 paper)	February proposal (from February 2020 paper)	Revised proposal	Comment
Effectiveness in promoting efficient prices (deter inefficient)	Low	Medium	Medium	MDAG expects the revised proposal to be materially better than the status quo. The degree of confidence on this issue has increased since February 2020, especially in light of the Evaluation Panel process. This process highlighted the uncertainties with the status quo and the associated potential for unintended outcomes to arise. The Evaluation Panel process also added confidence that a test based on economic efficiency principles would be superior to the status quo. (See also paragraphs 122 - 123).
Risk of adverse efficiency effects (including unintended consequences)	Low – medium (due to safe harbours)	Low	Low	MDAG accepts that submissions and the subsequent Evaluation Panel process identified problems with the 'Purpose Clause' in the February proposal. MDAG believes that the revised proposal addresses those issues. Accordingly, MDAG considers the revised proposal has a lower risk of triggering adverse efficiency effects than the status quo. (See also paragraphs 124 - 127).
Compliance and transaction costs for participants	Low (due to vagueness of HSOTC + safe harbours)	Low (medium for transition)	Low (medium for transition)	MDAG considers that the revised proposal has low compliance and transaction costs (once through the initial transition). (See also paragraph 128).
Implementation (time/effectiveness)	NA	Low (relative to other options)	Low (relative to other options)	MDAG considers that the revised proposal has low implementation costs.
Enforceability (includes legal certainty)	Low	Medium	Medium	MDAG considers that the revised proposal has better enforceability than the status quo – this assessment has been reinforced by the insights from the Evaluation Panel process which highlighted uncertainty about the status quo would be applied in practice.
Overall conclusion: balance of benefits and costs	Neutral (no evidence it is net positive)	Net positive	Net positive	MDAG considers the revised proposal will yield net benefits relative to the status quo. The degree of confidence has increased since February 2020, due to a better understanding of problems with the status quo, and improvements to the proposal made since February 2020.

135. In conclusion, for the reasons set out in Table 1, we consider that the revised proposal is likely to yield net benefits relative to the status quo.

Limits of proposed rule

136. If the scope and duration of significant market power in the spot market were to become deeper or more widespread, it may become increasingly difficult to proxy economic efficiency outcomes using a conduct rule. Among other things, the competitive market counterfactual (that is, a market without significant market power) would become harder to reference if it became less of an actual baseline. In this sense, the conduct rule would start to have 'blind spots' or be called on to do more 'work' than it is designed to do.

137. In this event, other remedies would need to be explored. As noted above, we agree with Prof Stephen Littlechild that from a first principles perspective, it is better to deal with potential market power *ex ante* rather than *ex post*, focusing on structure and incentives in designing remedies such as new entry, enforced divestment, contracts markets and the like, rather than on conduct.[86]

138. It is also worth noting that, if the Tiwai Point smelter closes, incentives to exercise market power in the New Zealand wholesale electricity market, particularly in the South Island, may become more problematic, possibly to a level that is beyond the capacity of our recommended provisions to mitigate. Whether that will occur is impossible to know at this time and will depend on factors such as any phase-down profile for smelter operation, the extent of other demand growth and prevailing transmission capacity.

Ensure that trading conduct provisions are technology neutral

139. For completeness, we note that in our recommendation paper to the Board of June 2020 on "Enabling participation of new generating technologies in the wholesale electricity market"[87], we recommended that the Authority should undertake a first-principles, root and branch approach to reviewing the Code to make it technology-neutral. We also highlighted that a piece-meal approach is likely to give rise to significant barriers to Code coherence and optimisation over time.

140. If and when that review is undertaken, references to "generators" in our proposed rule should be reviewed to make it technology-neutral, as appropriate. In the future, our rule should cover any party that sells electricity in the spot market, irrespective of how it has produced the electricity. It is not intended to discriminate between types of technology and the onus is on the offer behaviour of the party rather than its electricity generation source. Similarly, the Authority's review should cover the application of our proposed rule to demand-side participants not captured by the proposed rule, such as dispatchable demand.[88]

141. While offer behaviour of participants generating and selling electricity using newer technologies is currently insignificant, the Authority should anticipate and enable those developments in a technology-neutral manner.

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[86] See our February paper, page 36 at Part D.

[87] "*Enabling participation of new generating technologies in the wholesale electricity market*", Market Development Advisory Group, Recommendations Paper, June 2020. [online] Available at https://www.ea.govt.nz/development/work-programme/evolving-tech-business/participation-of-new-generating-technologies-in-the-wholesale-market/.

[88] Interruptible load offered as instantaneous reserve would be subject to the proposed rule through proposed clause 13.5A(2)(b).

Market Manipulation and Insider trading

142. Market manipulation and insider trading are both complex and relatively sophisticated categories of undesirable behaviour. Analogous markets have detailed sets of provisions in their codes with extensive definitions and requirements that identify and proscribe the behaviour in question. Those more detailed rules require a reasonably sophisticated understanding of how the behaviour might occur and the boundaries of when it becomes undesirable, which in turn shape careful legal definitions and linkages to relevant case law.

143. To the extent that the Authority would like the Code to cover other categories of behaviour that it may have hoped or perceived were covered by the HSOTC provisions[89], we would recommend that specific provisions covering those behaviours are put into the Code for that purpose at some future point. More targeted measures similar to those used in analogous markets are likely to be necessary to effectively capture categories of behaviour such as insider trading or market manipulation.

[89] See our February paper at paragraph 70, Figure 4.

Part E: Consistency with Authority's statutory consultation requirements

144. In making recommendations to the Board, our terms of reference[90] require us to:

(a) explain how the recommendations promote the Authority's statutory objective[91], which is to "promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers"; and

(b) explain how we have applied the Authority's Code amendment principles (as published in Part 1 of the Authority's consultation charter[92]) to arrive at our recommendations.

Consistency with Authority's statutory objective

145. In developing our recommendations, we have followed the same assessment approach used by the Authority when it proposes amendments to the Code. This requirement is set out in Section 32(1) of the Act, which requires that any (proposed) Code amendment is consistent with the Authority's statutory objectives -- and to explain why the amendment is necessary to promote competition, reliability and efficiency in the electricity industry for the long-term benefit of consumers. Our preliminary assessment is set out in our February paper[93] and the sections below present our final assessment with respect to this requirement.

146. The proposal is expected to improve productive, allocative, and dynamic efficiency in the wholesale electricity spot prices in circumstances where competition is weak (that is, where one or more parties has significant market power). In a nutshell, these efficiency gains[94] are obtained from:

(a) Purchasers avoiding diverting resources into managing risks of inefficiently high prices

(b) A reduction in price distortions associated with weak competition situations and so a reduction in 'dead-weight losses'

(c) Innovation and efficient investment over time from greater confidence in competition and lessening the perception of wholesale market price risk

147. These efficiency improvements will further promote the three limbs of the Authority's statutory objective—competition, reliability, and efficiency—for the long-term benefit of consumers.

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[90] ea.govt.nz. 2017. *Charter, Terms Of Reference And Operating Procedures*. [online] Available at: https://www.ea.govt.nz/development/advisory-technical-groups/mdag/charter-and-terms-of-reference/.

[91] Section 15 of the Electricity Industry Act 2010. [online] Available at: http://www.legislation.govt.nz/act/public/2010/0116/latest/DLM2634340.html.

[92] ea.govt.nz. 2012. *Consultation Charter.* [online] Available at: https://www.ea.govt.nz/assets/dms-assets/14/14242consultation-charter.pdf.

[93] See our February paper from 185.

[94] These gains are expected in relation to both 'local' pivotal supplier situations (events affecting an area smaller than the North or South Island) and 'widespread' pivotal supplier situations (North or South Island or national events).

148. Further, our proposal would advance the statutory objective of the Authority under section 15 of the Act because it will significantly reduce the legal and economic definitional problems that exist under the existing HSOTC provisions. This is important because a well-functioning efficient and competitive wholesale electricity spot market is central to delivering the Government's objectives for the electricity sector. Clear trading conduct rules play an important role in facilitating this. Our proposal sets out directly the assessment framework to be used when looking at an offer price, namely a comparison of the generator's (or ancillary service agent's) actual offer to the offer that would have been made if they had no significant market power. In addition, the proposal sets out when market power becomes significant by linking it to economic efficiency, and by extension, directly to the Authority's statutory objectives.

149. Our proposal will help the Authority to meet its objectives and functions under the Act, including in particular:

> "to undertake market-facilitation measures (such as providing education, guidelines, information, and model arrangements), and to monitor the operation and effectiveness of market facilitation measures."[95]

150. The Authority's Statement of Intent (SOI) for 2020-2024 sets out its intention to emphasise the importance:

> "…to actively build trust and confidence in the industry and regulation through greater transparency, understanding and improved behaviours. Consumers expect participants to be held to account to rules designed to provide long-term benefit"[96].

151. In assessing the Authority's action needed to address the current deficiencies in the HSOTC provisions, we were mindful of the need to consider the costs and benefits. The assessment methodology is described more fully in our February Paper.[97] In short, the CBA concluded that the benefits of the proposal are expected to outweigh the costs by up to $7.5 million (in present value terms). These benefits are from productive and allocative efficiency gains obtained by limiting the instances of inefficient price increases by pivotal suppliers when they are able to exercise significant market power.

Consistency with Authority's Code amendment principles

152. In recommending a replacement of the existing HSOTC provisions (clause 13.5A and 13.5B) in the Code, we consider that the requirements of the Authority's Code amendment principles (as published in Part 1 of the Authority's consultation charter) have been met. In particular, the current clause 13.5A is unclear in terms of the offer behaviour covered by the trading conduct provisions, the precise nature of the trading conduct obligation imposed on parties, and the extent to which the specific problems relating to the safe harbours in clause 13.5B lead to behaviour that is inconsistent with a high standard of trading conduct. For these reasons we consider that Principle 2 (clear regulatory or market failure) is met.

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[95] Section 16(1)(f) of the Electricity Industry Act 2010. [online] Available at: http://www.legislation.govt.nz/act/public/2010/0116/latest/DLM2634340.html.

[96] ea.govt.nz. 2020. *Statement of intent 01 July 2020 – 30 June 2024.* [online] Available at: https://www.ea.govt.nz/assets/dms-assets/27/27020Statement-of-Intent-2020-2024.pdf.

[97] See our February paper p77 at Annex 4.

153. We note that the proposed amendment is consistent with Principle 1 (lawfulness) and with Principle 3 (quantitative assessment) which estimated substantial gains from a clearer trading conduct rule compared to the status quo.

154. Because the CBA on our proposal is qualitative (with quantitative sensitivity analysis), the tie-breaker condition is applicable. In this regard, we note that the proposed Code amendment is consistent with Principle 5 (greater competition), Principle 6 (market solution) and Principle 8 (non-prescriptive options).

Legislation requirements relating to consultation

155. For our February 2020 paper, the Authority Board noted to MDAG that section 39(3)(c) of the Act provides for the Authority to proceed directly to change the Code, without undertaking its own consultation, if it is satisfied on reasonable grounds that there has been adequate prior consultation, such as by an advisory group. We have therefore prepared this discussion paper to allow the Authority to proceed on this basis should it consider the statutory test is met.

156. Our February paper included legal drafting for Code changes to implement our proposal and an assessment of the proposal against the Authority's objectives in section 15 of the Act. It also included the different elements of the regulatory statement ordinarily required for a proposed Code amendment under section 39(2) of the Act, including a cost-benefit analysis of the proposal. This was not intended to pre-empt or predetermine the Authority's own consideration of the matter, but simply positions the Authority to better minimise duplication of effort as appropriate.

157. This recommendation paper also includes legal drafting for Code changes to implement our proposal and, as outlined above, an assessment of the proposal against the Authority's objectives in section 15 of the Act. It also included the different elements of the regulatory statement ordinarily required for a proposed Code amendment under section 39(2) of the Act and sets out the evidence showing how the proposed rule is likely to yield net benefits relative to the status quo. Again, this is not intended to pre-empt or predetermine the Authority's own consideration of the matter, but simply positions the Authority to better minimise duplication of effort as appropriate. Clearly, it is for the Authority to decide whether it wishes to undertake further consultation on our recommended Code change.

158. In their submissions on our October paper, Contact, Mercury, Genesis and Meridian called for the Authority to carry out further consultation with market participants if the Authority were to decide to progress MDAG's proposal. Haast, Electric Kiwi and the independent retailers strongly consider MDAG's processes of consultation have been sufficiently comprehensive to make consultation by the Authority unnecessary. Nova, Trustpower and MEUG did not express a view on this matter.

Appendices

159. This paper has four appendices attached:

(a) Appendix 1: Current HSOTC provisions in the Code

(b) Appendix 2: Summary of submissions and cross submissions on our paper of February 2020

(c) Appendix 3: Summary of submissions on our paper of October 2020

(d) Appendix 4: Other options considered

Appendix 1: Current HSOTC provisions in the Code

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

(1) Each **generator** and **ancillary service agent** must ensure that its conduct in relation to **offers** and **reserve offers** is consistent with a high standard of trading conduct.

(2) Subclause (1) applies when—

(a) a **generator** submits or revises an **offer**; or

(b) an **ancillary service agent** submits or revises a **reserve offer**.

13.5B Safe harbours for clause 13.5A

(1) A **generator** complies with clause 13.5A if—

(a) the **generator** makes **offers** in respect of all of its generating capacity that is able to operate in a **trading period**; and

(b) when the **generator** decides to submit or revise an **offer**, it does so as soon as it can; and

(c) in the case of a **generator** that is **pivotal**,—

(i) prices and quantities in the **generator's offers** do not result in a material increase in the **final price** at which **electricity** is supplied in a **trading period** at any **node** at which the **generator** is **pivotal**, compared with the **final price** at the **node** in an immediately preceding **trading period** or other comparable trading period in which the **generator** is not **pivotal** at that **node**; or

(ii) the **generator's offers** are generally consistent with **offers** it has made when it has not been **pivotal**; or

(iii) the **generator** does not benefit financially from an increase in the **final price** at which **electricity** is supplied in a **trading period** at a **node** at which the **generator** is **pivotal**.

(2) A **generator** does not breach clause 13.5A only because the **generator** does not comply with subclause (1).

(3) An **ancillary service agent** complies with clause 13.5A if—

(a) the **ancillary service agent** makes **reserve offers** in respect of all of its capacity to provide **instantaneous reserve** that is able to operate in a **trading period**; and

(b) when the **ancillary service agent** decides to submit or revise a **reserve offer**, it does so as soon as it can; and

(c) in the case of an **ancillary service agent** that is **pivotal**,—

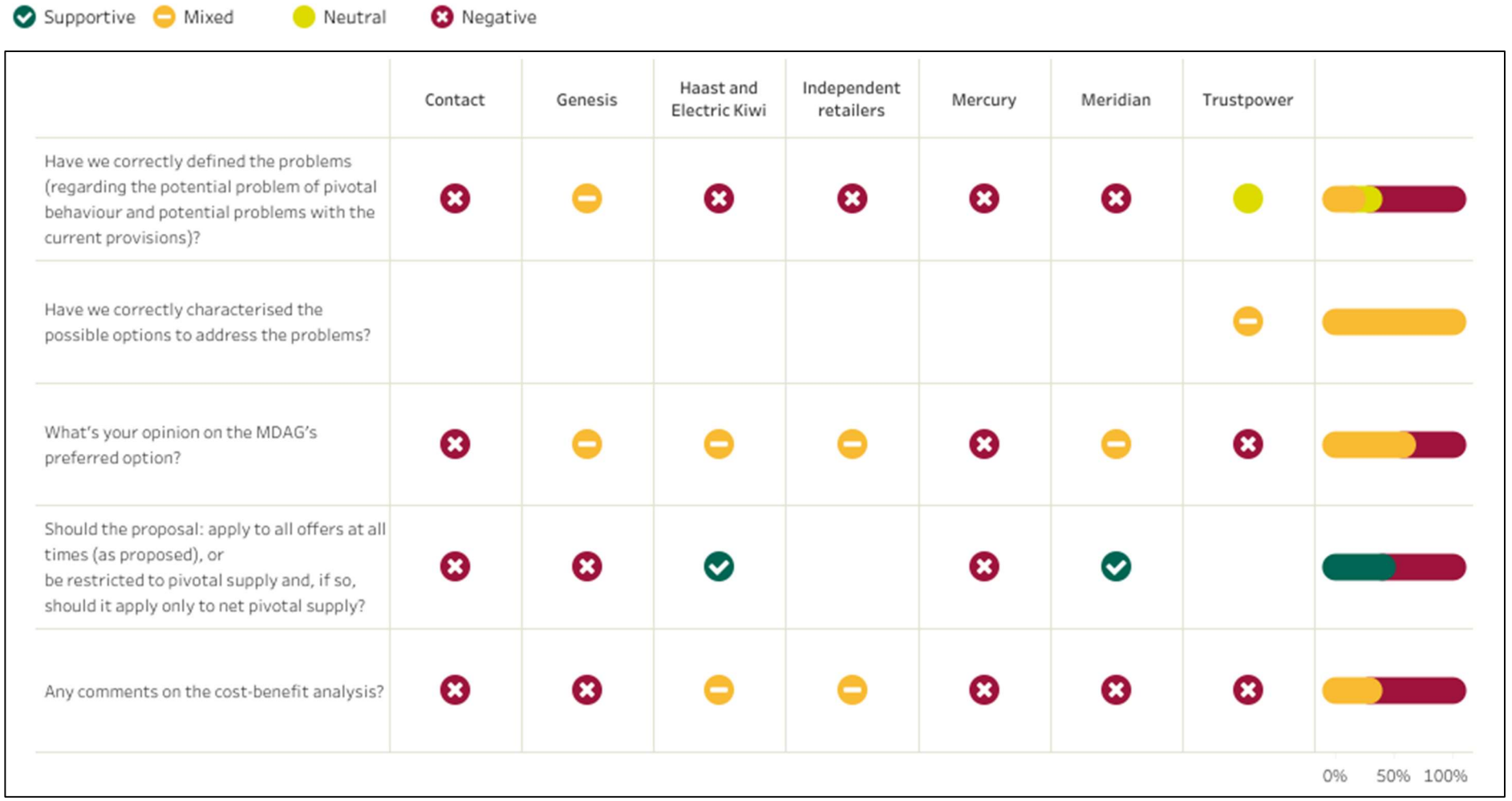
(i) prices and quantities in the **ancillary service agent's reserve offers** do not result in a material increase in the **final reserve price** in a **trading period** in an **island** in which the **ancillary service agent** is **pivotal**, compared with the **final reserve price** in the **island** in an immediately preceding **trading period** or other comparable **trading period** in which the **ancillary service agent** is not **pivotal**; or

(ii) the **ancillary service agent's reserve offers** are generally consistent with **reserve offers** it has made when it has not been **pivotal**; or

(iii) the **ancillary service agent** does not benefit financially from an increase in the **final reserve price** in a **trading period** in an **island** in which the **ancillary service agent** is **pivotal**.

(4) An **ancillary service agent** does not breach clause 13.5A only because the **ancillary service agent** does not comply with subclause (3).

Appendix 2: Summary of submissions and cross submissions on our paper of February 2020



Problem definition

Question: have we correctly defined the problems (regarding the potential problem of pivotal behaviour and potential problems with the current provisions)?

Contact		Exercise of market power not a problem.
Genesis		There are occasions when generators have ability to exercise unfettered market power.
Haast and Electric Kiwi		Problem bigger than MDAG indicated. Need to look at sub-Island pivotal situations. Market manipulation and insider trading an issue too.
Independent retailers		Market power is an issue. Market manipulation also an issue.
Mercury		No evidence that pivotal situations have led to significant long-term consumer detriment.
Meridian		There are significant problems with the current provisions.
Trustpower		Not sure (based on the evidence presented) that there is a problem to address.

Characterisation of different options

Question: have we correctly characterised the possible options to address the problems?

- Most submitters provided no comment on this question.
- Trustpower submitted that:
  - more options analysis needed to be undertaken
  - the focus should be on structure and incentive options, rather than conduct
  - there should be consideration of whether the HSOTC provision should be deleted altogether and rely on other methods of managing market power.

MDAG's preferred option

Question: what's your opinion on the MDAG's preferred option?

- Several parties thought the proposal was a form of price regulation and more suited for a monopoly/regulated market.
- However, three submitters provided conditional support for the proposal.

Contact		Proposal is a significant departure from the current wholesale electricity market design, and it mandates specific market outcomes which are usually a feature of regulated markets.
Genesis		Proposal is an improvement on HSOTC but is not appropriately targeted at the problem. The proposal also follows a legal and economic approach that has been developed for monopolies and is not applicable to workably competitive markets. Have made an alternative proposal.
Haast and Electric Kiwi		Support proposal with some enhancements. HSOTC clause should be retained as a catch-all. Note there may be alternative trading conduct rules that are worth considering.
Independent retailers		Support proposal with some enhancements. HSOTC clause should be retained as a catch-all. Note that suggestions by other parties that liken proposal to price control are not a reasonable or accurate representation of the proposal. Consider proposal would provide more clarity.
Mercury		The net effect of the MDAG proposal will be to introduce de-facto price regulation on the wholesale market. Disagree that efficient prices will always equate to underlying economic costs. Efficient prices are set through the price discovery process in competitive markets.
Meridian		Tentatively support, conditional on re-drafting of purpose statement and a full CBA by the Authority. Proposed purpose statement suggests the application of an entirely different test to that set out in subclause 1.
Trustpower		Proposal is difficult to understand and apply in real time. Wellington International Airport case not relevant as deals with a monopoly. Concern with how proposal would interact with process of price discovery. Conduct provisions are not the best tool for addressing market power in electricity markets.

Application of proposal to all offers

Question: should the proposal:

- *apply to all offers at all times (as proposed), or*
- *be restricted to pivotal supply and, if so, should it apply only to net pivotal supply?*

- No consensus on whether proposal should apply to all offers or just pivotal supply.
- No support for proposal to apply only to net pivotal supply.
- Independent Retailers and Trustpower did not comment on this question.

Contact	Pivotal only	Not necessary to apply to all offers for a market that is fundamentally competitive.
Genesis	Pivotal only	Don't understand why it applies to all offers when MDAG has identified that the problem only exists when a generator is pivotal.
Haast and Electric Kiwi	All offers or all pivotal	Do not support limiting to net pivotal—gross pivotal situations can give rise to concerns about abuse of market power.
Mercury	Pivotal only	Do not support it applying to all trading periods.
Meridian	All offers	It is challenging to determine when generators are gross or net pivotal.

Cost-benefit analysis

Question: any comments on the cost-benefit analysis?

- The five gentailer submitters thought the CBA underestimated the costs.
- Haast and Electric Kiwi thought the CBA understated the benefits.
- Genesis, Meridian, and Trustpower said a more robust/quantitative CBA was needed given the importance of the proposed change.
- Haast and Electric Kiwi and Independent retailers suggested some ways in which a more quantitative CBA could be undertaken.

Cost-benefit analysis (cont.)

Question: any comments on the cost-benefit analysis?

Contact	Questionable that costs will be negligible—expect alleged breaches to increase and Authority will need to increase monitoring and compliance
Genesis	Agree that quantitative CBA difficult due to subjective judgements, but given importance of proposed change, suggest MDAG should seek to do a full quantitative CBA. MDAG underestimates the cost of generators offering at inefficiently low prices due to the uncertainty of falling foul of the too much, too long standard. Don't agree that additional staffing costs for the Authority and participants will be minimal/nil.
Haast and Electric Kiwi	CBA understates benefits as only considers efficiency benefits and not consumer price benefits. Reduction in wealth transfers from consumers is likely to be the most substantial benefit. Provide some suggestions on how a more quantitative CBA could be undertaken.
Independent retailers	If MDAG was going to try developing a quantitative CBA it could consider modelling the results of more competitive outcomes using vSPD.
Mercury	Do not agree that proposal will come with negligible cost—there is potential for distorted generation offer behaviour and increased regulatory intervention in response to the economic cost-based trading conduct test.
Meridian	CBA is inadequate. CBA does not assess how the proposal might distort price discovery and the economic cost of these distortions. A full CBA is needed and should be consulted on. Sapere showed that the proposal erodes the price discovery function of the market and replaces it with a form of discretionary price control regulation.
Trustpower	A more robust CBA needed for reform of this magnitude. Another CBA should be done that includes assessing the proposal against other options. Think proposal will increase costs due to complexity of test and potential for higher compliance costs, vexatious claims, and rule breaches.

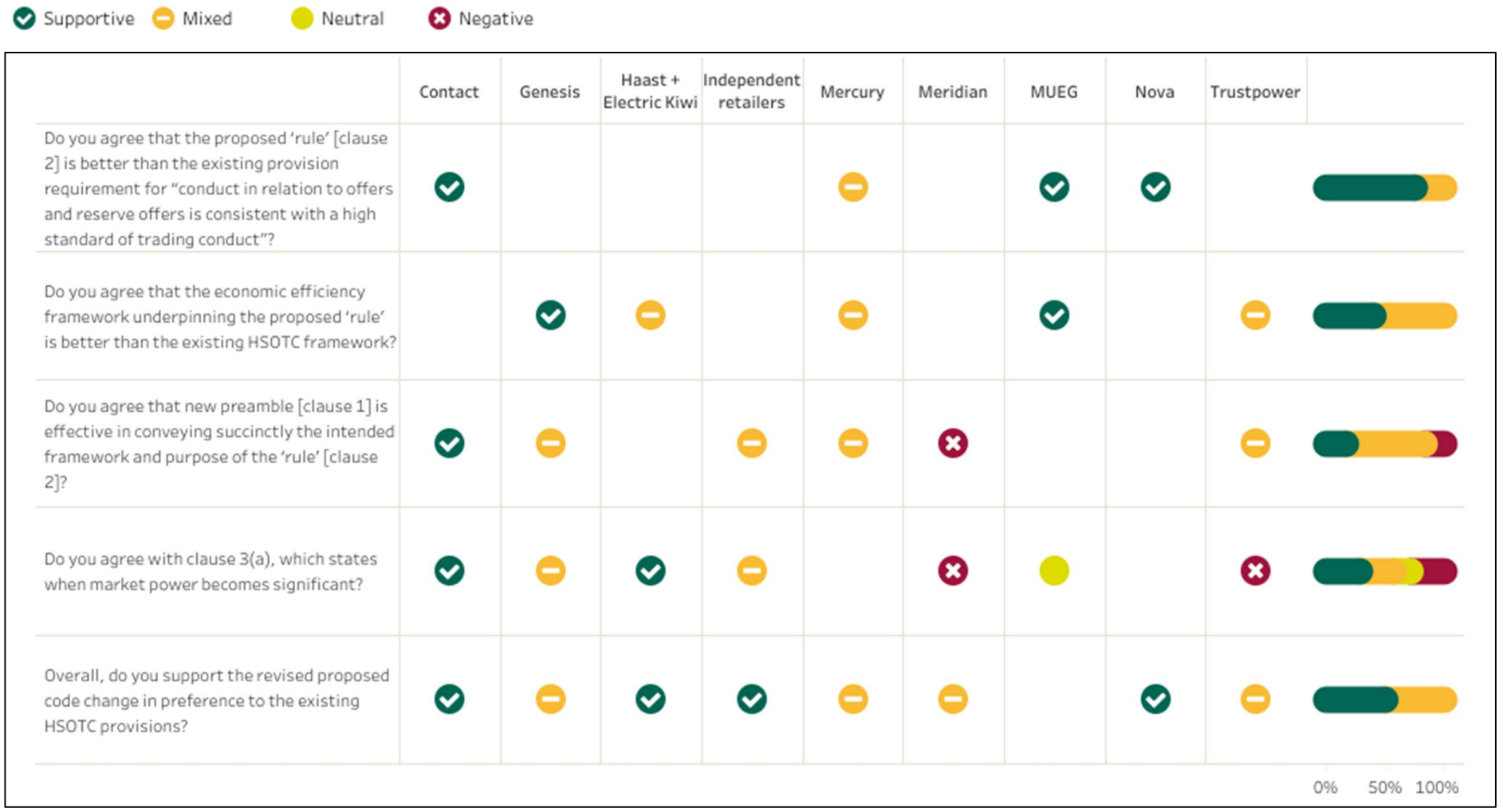
Need for Authority consultation

- Three submitters (Genesis, Meridian, Trustpower) don't support bypassing Authority consultation.
- Two submitters (Haast and Electric Kiwi, Independent Retailers) support bypassing Authority consultation.
- Contact and Mercury had no comment.

Other issues and suggestions

Submitter(s)	Comment
Contact	Recommend the Authority consider introducing specific measures to ensure cases are legitimate (eg, a two-step process or an Early Resolution Team to quickly respond to and progress/dismiss claim allegations).
Haast and Electric Kiwi	MDAG should recommend the Authority review whether the $0.00/MWh price floor in clause 13.15 of the Code can be removed.
Haast and Electric Kiwi, Independent retailers	Support for more stringent monitoring and enforcement.
Haast and Electric Kiwi, Independent retailers	Review has taken too long.
Meridian	Concerned that MDAG has misrepresented and seemingly misunderstood the 2 June 2016 decisions.
Trustpower	Need to develop case studies to see how rules might apply "at the trading desk".

Appendix 3: Summary of submissions on our paper of October 2020



Question: Do you agree that the proposed 'rule' [clause 2] is better than the existing provision requirement for "conduct in relation to offers and reserve offers is consistent with a high standard of trading conduct"?

Contact		Clause 2 is sound and clearer than the existing HSOTC rule
Genesis		The proposed rule in clause 2 is a better approach, as it more clearly identifies the situation in which it is intended to apply, and the type of conduct it is meant to prevent. However, the proposed rule does not resolve all ambiguity concerns. An economic efficiency test will always be subject to debate and interpretation.
Haast and Electric Kiwi		Yes - Electric Kiwi and Haast Energy Trading (Haast) support MDAG's revised HSOTC proposals.
Independent retailers		Yes - We agree with MDAG that its "… revised proposed code change is considerably better than the existing high standard of trading conduct provisions and should be put in place as an improved mechanism for mitigating the risks of significant market power".
Mercury		Agree with Clause 2 drafting but not the overall proposal as there are several issues not yet resolved
Meridian		Yes
MEUG		Yes
Nova		Yes - Nova supports the proposed rule in the form presented
Trustpower		The removal of safe harbour provisions increases uncertainty and raises compliance and interpretation risk

Question: Do you agree that the economic efficiency framework underpinning the proposed 'rule' is better than the existing HSOTC framework?

Contact		
Genesis		Economic efficiency framework does not intend to prevent all exercise of market influence by generators
Haast and Electric Kiwi		Mixed -It would not be sufficient to treat "economic efficiency" as a catch-all for efficiency, competition and reliable supply. Such an approach would effectively be contrary to the statutory objective in section 15 and render the important references to competition and reliable supply superfluous.
Independent retailers		No Comment
Mercury		Overall proposal has several issues that are not yet resolved
Meridian		No Comment
MEUG		Yes
Nova		No Comment
Trustpower		Need clarity around both the market definition and the behaviour which could be seen to be an abuse of market power

Question: Do you agree that new preamble [clause 1] is effective in conveying succinctly the intended framework and purpose of the 'rule' [clause 2]?

Contact		Yes -it provides useful guidance and correctly recognises the predominance of competition and resulting competitive discipline that occurs in the NZ spot market
Genesis		Genesis agrees that the new preamble accurately conveys that: The wholesale electricity market is generally competitive, and designed so that effective rivalry among market participants delivers economic efficiency outcomes for the long-term benefit of consumers. In those circumstances, regulatory control of offer prices and volume is undesirable
Haast and Electric Kiwi		No Comment
Independent retailers		Ensure that all three statutory objectives (not just efficiency) are captured in the rule. Advocating for changes : The reference to "net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency" in MDAG's definition of significant market power articulates this in an overlapping but different way, which may result in potential conflicts, and legal arguments about the correct interpretation and which takes prominence.
Mercury		Overall proposal has several issues that are not yet resolved
Meridian		Suggested various changes to the wording of the clause
MEUG		No Comment
Nova		No Comment
Trustpower		Mixed - We prefer the revised drafting (new preamble) to the previous purpose clause. This is because we thought there was a high risk that the references to costs in the previous purpose clause could result in an application of the clause by the Rulings Panel and/or High Court in a manner similar to the cost-based regulation of monopolies. We still have concerns that the new test could lead to a proliferation of complaints until interpretations were settled. Concern that vexatious allegations will be made

Question: Do you agree with clause 3(a), which states when market power becomes significant?

Contact		
Genesis		Concerns on how to interpret in practice
Haast and Electric Kiwi		Yes - We support the independent retailer recommendations to revise the definition of significant market power, but our support for the MDAG proposal is not contingent on these changes being made.
Independent retailers		Ensure that all three statutory objectives (not just efficiency) are captured in the rule Mixed-We recommend tweaking the proposed definition to align with the Yarrow and Decker definition, and to ensure it captures all three of the limbs of the section 15 statutory objective
Mercury		No Comment
Meridian		Risk remains because the Significant Market Power test has to be applied in each instance. "Proposed clause 3(a) is inconsistent with the economic texts upon which MDAG claims it is based and would result in unintended consequences."
MEUG		No Comment
Nova		No Comment
Trustpower		Need to better define the market and duration for which this is applicable

Question: Overall, do you support the revised proposed code change in preference to the existing HSOTC provisions?

Contact		Yes- revised proposal addresses concerns from earlier proposal
Genesis		Concerns on how to interpret in practice. Genesis supports the revised proposed code change in preference to the existing HSOTC provisions but believes it will be necessary to develop separate guidelines that will provide practical assistance to inform offer conduct.
Haast and Electric Kiwi		Yes - We agree with MDAG that the revised HSOTC proposal is superior to the original MDAG proposal and the current HSOTC rules. Electric Kiwi and Haast Energy Trading (Haast) support MDAG's revised HSOTC proposals.
Independent retailers		Yes - we support the revised HSOTC proposal regardless of whether our recommendations are adopted.
Mercury		
Meridian		Meridian prefers the proposal to the existing HSOTC provisions. However, we do not wholly support the revised proposal.
MEUG		No Comment
Nova		Yes
Trustpower		The problem that the rule is trying to resolve needs to be more clearly defined. We support the new provisions over the MDAG's previous version however Trustpower, as an organisation, is not yet clear about the harm that is being addressed given the paucity of cases to date.

Additional Comments

Genesis	Need for more guidance on how to interpret the rule and further consultation by the Authority.
Independent retailers	Need for more guidance on how to interpret the rule but there is no need for further consultation by the Authority.
Mercury	Need for more guidance on how to interpret the rule, further consultation by the Authority and a more comprehensive CBA.
Meridian	Need for more guidance on how to interpret the rule, further consultation by the Authority and a more comprehensive CBA.
MEUG	Need for more guidance on how to interpret the rule and a more comprehensive CBA.
Trustpower	Need for more guidance on how to interpret the rule and a more comprehensive CBA.

Appendix 4: Other options considered

160. We have evaluated various alternatives when developing the proposed provisions. These were all duly considered at length but were ultimately discarded after weighing their pros and cons relative to our proposal. The sections below outline the main alternatives that were considered in-depth.

No trading conduct provisions in the Code

161. The first alternative was whether the Code should include trading conduct provisions in the first place. One option is to leave it to the dynamic market forces, through the process of innovation and entry of new market players, to curtail the exercise of market power and inefficient offer behaviour would be competed away. However, this dynamic process typically eventuates over the longer term, and in the meantime, unfettered abuse of significant market power would cause substantial economic harm.

162. We therefore concluded that safeguards are required in situations where competition is weak or absent, and to discipline offer behaviour in these circumstances.

No purpose or 'supporting' clause

163. Another alternative was to exclude any form of purpose or supporting clause from the trading conduct provisions. The rule would therefore consist of a standalone objective clause (clause 2).

164. This approach would have simplified the rule but would also leave it more open to uncertainty in its interpretation. Excluding any form of supporting text presents a greater risk that a Rulings Panel or a court misinterprets the intended meaning of the rule and could potentially arrive at a decision that is dissimilar from what is intended. It would also be likely that a Rulings Panel or a court would require a longer period to evaluate the rule and establish a clear interpretation when it applies it to a breach allegation.

An explanatory note in the Code

165. A third alternative that we have carefully considered is an 'Explanatory Note', which in concept would sit inside the Code but would not form part of the Code's legal provisions.

166. This note was intended to be a succinct explanation of the purpose and rationale for the operative clause and to be set in the Code to be easily accessible and ensure that it is read in conjunction with the operative clause.

167. The concept was to:

(a) provide a more informal explanation of 'the rule' in a manner less constrained by the technical drafting requirements that apply to provisions of the Code,

(b) while at the same time preserving its neutrality, authority and accessibility as part of the Code, which would also make it more enduring as an explanation of the purpose and rationale for the new provisions,

(c) rather than merely a 'guideline' from the Authority, which is simply an expression of Authority's view, which is also subject to greater risk of change, less accessibility and less neutrality from the point of view of the Rulings Panel or courts.

168. We explored also including two basic indicators of economic efficiency and significant market power, as well as referring to the importance of opportunity costs and scarcity rents.

169. It became clear, however, that an 'Explanatory Note' would be prone to the risk either that an express caveat to its use would render it relatively meaningless, or that it would be treated as akin to a code provision and therefore subject to the same rigours of statutory interpretation, which could result in creating conflict or confusion with the code provisions, and therefore substantially dilute its purpose and utility.

170. Further, the Authority may also have been reluctant to introduce an explanatory note due to its perceived risk of creating a precedent that could lead to a proliferation of explanatory notes (a view that MDAG does not necessarily agree with).

171. We also understand that use of explanatory note-like devices in the National Electricity Market in Australia have proved problematic.

172. We consider that the recommended provisions achieve the policy and drafting objectives better than the explanatory note options we considered.

Alternatives considered in the Discussion Paper

173. Several alternatives were assessed at a high level in our February paper[98], which built on options considered by the WAG in the process leading to the HSOTC provisions. The WAG had considered seven options, in no particular conceptual structure, which were developed in consultation with the Authority Board[99].

174. A [trading] conduct provision -- of which six variations were considered:

(a) Prohibition on fraudulent activity or prohibition on deceitful acts;

(b) Prohibition on market manipulation;

(c) Prohibition on abusing dominant position;

(d) Requirements to observe ethical standards;

(e) Requirement to act in good faith; or

(f) Requirement to observe high standards of trading conduct:

i. A declaration when single generators are expected to be net pivotal and apply earlier gate closure for net pivotal generators' offers (proposed by the Board[100]);

ii. Improve incentives on the grid owner to mitigate pivotal supplier risk via changes to the outage protocol;

[98] See our February paper, p36 at Part D.

[99] WAG, May 2013 at 4.3.

[100] The Board also proposed that this option should include advanced publication of the offer prices of pivotal generators that are subject to early gate closure – see WAG, Sept 2013 at 3.1.4(a)(iii).

iii. Making the grid owner accountable for increased spot market costs caused by pivotal suppliers during outages (proposed by Board[101]);

iv. A general cap on offers or spot prices in all trading periods;

v. A temporary capping mechanism on pivotal supplier offers in a pivotal region; and

vi. Contract offer obligations on pivotal suppliers.

175. The WAG had also considered the option of relying on the Commerce Act to address trading conduct issues from pivotal supplier situations[102]; and also considered the effectiveness of the undesirable trading situation (UTS) process as a substitute to trading conduct provisions in the Code[103]. However, both options were deemed to be ineffective for a variety of reasons, as detailed in their report[104].

[101] The Board's aim with this option was to encourage Transpower to contract with generators for pivotal generation during outages - see WAG, Sept 2013.

[102] WAG, May 2013 at 4.1.1.

[103] WAG, May 2013 at 4.2.2 and 4.2.3.

[104] Ibid.

Glossary of abbreviations and terms

ACER	Agency for the Cooperation of Energy Regulators (Europe)
Authority	Electricity Authority
Code	Electricity Industry Participation Code (2010)
LRMC	Long Run Marginal Cost
MDAG	Market Development Advisory Group
NRA	National Regulatory Authority (Europe)
REMIT	Regulation on wholesale energy market integrity and transparency (REMIT) (Europe)
SRMC	Short Run Marginal Cost
Supplier	A generator or an ancillary service agent as defined in Electricity Industry Participation Code (2010)
UTS	Undesirable Trading Situation, is a situation that threatens, or may threaten, confidence in, or the integrity of, the wholesale market that cannot otherwise be resolved satisfactorily under the Code
WAG	Wholesale Advisory Group
Wholesale market	The spot market, hedge market and ancillary services market