**Publication Date**: 21 October 2020

**Submissions due**: 5pm, 5 November 2020

# MARKET DEVELOPMENT ADVISORY GROUP

## REVIEW OF THE TRADING CONDUCT PROVISIONS:

SUPPLEMENTARY CONSULTATION PAPER

# Acknowledgements

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

- Tony Baldwin (Chairperson)
- Paul Baker
- Matthew Cleland
- Stu Innes
- Andrew Kerr
- Tony Oosten
- Rebecca Osborne
- Ann Whitfield
- Fiona Wiseman
- Al Yates

The MDAG would also like to acknowledge the contribution to the review of the trading conduct provisions in the Code by previous members of the MDAG during the period of their membership.

# Outline

# Preliminary

# Purpose

- In February 2020, MDAG consulted on a proposal to replace the current high standard of trading conduct provisions (clauses 13.5A and 13.5B) in the Electricity Industry Participation Code 2010 with new trading conduct provisions.

- After considering feedback from submissions and the findings from the evaluation panels process, MDAG has changed some aspects of its original proposal. The MDAG is seeking your feedback on these changes.

- This revised proposal is expected to improve the efficiency of wholesale electricity spot prices in circumstances where competition is weak. This will help to promote the three limbs of the Authority's statutory objective—competition, reliability, and efficiency—for the long-term benefit of consumers. Feedback from this short consultation will inform the MDAG's recommendations to the Authority.

# How and by when to make a submission

- Our preference is to receive submissions in electronic format (Microsoft Word) in the format shown in Appendix A. Submissions in electronic form should be emailed to MDAG@ea.govt.nz with "Review of the Trading Conduct Provisions—Supplementary Consultation Paper" in the subject line.
- If you cannot send your submission electronically, post one hard copy to either of the addresses below, or fax it to 04 460 8879

| Postal address | Physical address |
|---|---|
| Submissions<br>Electricity Authority<br>PO Box 10041<br>Wellington 6143 | Submissions<br>Electricity Authority<br>Level 7, Harbour Tower<br>2 Hunter Street<br>Wellington |

- Please deliver your submissions by 5pm on Tuesday 5 November 2020.
- We will acknowledge receipt of all submissions electronically. Please contact us at MDAG@ea.govt.nz or 04 471 8628 if you don't receive electronic acknowledgement of your submission within two business days.

# Publication of your submission

- Please note the MDAG wants to publish all submissions it receives. If you consider that we should not publish any part of your submission, then:
  - (a) indicate which part should not be published
  - (b) explain why you consider we should not publish that part
  - (c) provide a version of your submission that we can publish (if we agree not to publish your full submission).
- If you indicate there is part of your submission that should not be published, we will discuss with you before deciding whether to not publish that part of your submission.
- However, please note that all submissions we receive, including any parts that we do not publish, can be requested under the Official Information Act 1982. This means we would be required to release material that we did not publish unless good reason existed under the Official Information Act to withhold it. We would normally consult with you before releasing any material that you said should not be published.

# Initial proposal

# Initial proposal – 'The Rule'

- In its discussion paper of February 2020, MDAG proposed a complete replacement of high standard of trading conduct (HSOTC) provisions in the Code (clauses 13.5A and 13.5B and the definition of "pivotal").
- The proposed provisions had two parts – the **'rule'** and the **purpose** clause
- The **'rule'** was set out in two clauses, both identical except that:
  - Clause 1 applied to generators' offers, and
  - Clause 2 applied to ancillary service agents' reserve offers.
- These operative clauses are set out in the adjoining dialogue box

(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**.

# Initial proposal – The purpose clause

- The adjoining dialogue box sets out the purpose clause we proposed in February 2020
- It tried to express in a single sentence the essence of economic efficiency, which underpins 'the rule' (in the previous slide). 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 NZ system

(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).

[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) "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.

# Evaluation

# Submissions and cross-submissions

- A summary of submissions and cross-submissions received on the February 2020 discussion paper are set out here
- Stakeholder responses fell into two broad groups :
  - Those that supported the Code amendment 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.
  - Those that did not support the Code amendment. Among this group, the purpose clause was also a key area of concern.
- Some stakeholders expressed concerns that the purpose clause could unintentionally introduce de facto price control to the electricity spot market.
- Concern was also expressed that the proposal might encourage vexatious breach allegations
- This is a very high-level summary of submissions. A fuller discussion of views will be set out in the MDAG's final report to the Authority

# Evaluation Panels

- On completion of the submission and cross-submissions stages, MDAG established two independent evaluation panels acting as proxies for the Rulings Panel and Courts. Their task was to interpret and apply the existing code, and MDAG's proposed code, to a menu of case studies in an objective and rigorous manner.
- The case studies were developed in consultation with all parties who made submissions, drawing on real world situations.
- Each Panel was also invited to comment on how MDAG's proposed code could be improved to better achieve the policy objective.
- The panels were not asked to arbitrate across competing viewpoints among stakeholder submissions.
- The two panels worked independently from each other. Panel ABD comprised:
  - Hon Raynor Asher QC, former Judge of the Court of the Appeal;
  - Dr Alan Bollard, Chairperson of the Infrastructure Commission; and
  - Pat Duignan, Finance and Economics Expert Lay Member of the High Court.
- Panel HBR comprised:
  - Hon Rhys Harrison QC, former Judge of the Court of Appeal;
  - Dr Mark Berry, former Chair of the Commerce Commission; and
  - Iain Rennie, former State Services Commissioner.

# Evaluation panels *(cont'd)*

- The report of Panel ABD is here. The report of Panel HBR is here
- 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
- The overall views of the panels were as follows:
  - Both panels considered that the current code was unsatisfactory due (among other things) to its lack of legal meaning and ambiguity.
  - Both panels supported the adoption of an economic-based test (as proposed by the MDAG), in preference to the current code.
  - In relation to the operative clauses in the MDAG's proposal (clauses 13.5A(1) and (2)), both panels considered that these are fundamentally sound.
  - Both panels thought the purpose statement (clause 13.5A(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 and/or that an explanatory note could be used within the code to convey context and framework of the operative clauses.
  - Neither panel considered that de facto price control was a likely outcome from the MDAG's proposed provisions. However, based on the evaluation panel process, MDAG is concerned the purpose clause might be read as inviting a court to use an overly simplified comparison of prices and costs as a yardstick for determining whether the operative clause has been breached. Such an outcome is not intended.

# MDAG's considerations

- Reflecting carefully on the findings and recommendations of the evaluation panels, MDAG concluded that:
  - The '**rule**' (in the two operative clauses) is sound and should be retained
  - The **purpose** clause is problematic – there is an apparent risk that it may not work as intended; and
  - 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), which ever is optimal from a technical legal drafting perspective.
- We have taken advice from leading specialists in legislative drafting and tested a range of formulations.
- We have also consulted with Hon Rhys Harrison QC and Iain Rennie, who were panel members, on their view of alternative formulations.

# Revised proposal

# ‘The rule’ – revised proposal

- As noted earlier, MDAG agrees with the Evaluation Panels that the ‘rule’ is sound.
- We are proposing only these minor changes:
  - “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;
  - “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
  - tweaks to improve the plain English flow without changing the meaning (eg 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).

MDAG’s revised proposal (clean) –

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.

With changes tracked –

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]*

# Purpose clause – Revised proposal

- As shown in the adjoining box, we propose to:
  - **delete** the purpose clause and **replace** it with a simplified preamble clause that leads into the 'rule', and
  - **add** a new clause 3 with an explanation of when market power become "significant"
- We consider that this better achieves the drafting goal of framing:
  - the 'rule' in the context of the competitive disciplines that generally apply in the market [clause (1)(a)];
  - the problem that the 'rule' is addressing, namely clause (1)(b); and
  - when market power becomes significant [clause (3)(a)] (which is discussed further on the next slide).
- In relation to the passive construction in clause (1)(a), "it is expected" refers to the expectation of the spot market.

(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**).

# "Significant market power"

- We have considered submissions carefully and concluded that our rationale for "significant market power" as the yardstick in the 'rule' remains robust. This rationale is outlined in our consultation paper of February 2020 at paras 119-123.
- To recap, in its pure definition, market power is "the ability to affect the market price even a little and even for a few minutes" [see Dr Steven Stoft, "Power System Economics," at p 318, which is cited in ComCom, May 2009 at 242]
- As Prof George Yarrow and Dr Chris Decker point out[1], these definitions imply that market power is almost ubiquitous – modest levels of price influence are generally beneficial, hence their ubiquity. They 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.

Footnote 1 - Yarrow and Decker, Nov 2014, at page 21. Refer to MDAG's February 2020 consultation paper at paras 119-123 for more detail and sources of authorities on the content of this slide.

- 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.
- 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.
- As outlined in para 119 of our February consultation paper, we are not using 'substantial', which is used in the prohibition on taking advantage of market power under section 36 of the Commerce Act. There are two key reasons for this:
  - 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.
  - Second, section 36 cases involve showing that a party acted with a clear anti-competitive purpose beyond simply raising prices [as noted in WAG, May 2013 at 4.1.1]. 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.

# "Significant market power" *(cont'd)*

- 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 [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]
- The notion of net adverse impact in our proposed clause (3)(a) draws on this concept:

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

- Economic efficiency is now well established as a frame of reference in Court and Commerce Commission decisions (see for example, *Wellington Airport* [2013] NZHC 3289 at [14])

# General observations

# General observations – Economic costs and prices

- Our revised proposal does not refer expressly to economic costs or prices. This is to avoid the risk, which was present in our initial proposal, of such a reference being taken out of context or causing the rule to be applied in some sort of cost-based mechanistic manner, which was and is not the intention of our proposal, initial or revised.
- Further, our proposal (initial and revised) 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.

The 2nd, 3rd and 4th bullet points on this slide are outlined more fully, with relevant authorities, in Annex 3 of MDAG's February 2020 consultation paper.

- 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.
- 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[1].

Footnote 1 above – see 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

- The net present value of efficient SRMCs should equal 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.

# General observations – Rough indicators

- Expressed in more informal (and therefore less precise) terms, the counterfactual required in 'the rule' [clauses (2)(a) and (b)] is intended to approximate the offer that would have occurred if the offer in question had been subject to the competitive disciplines situation referred to in clause (1)(a) that generally acts as a discipline on offer behaviour in the spot market.[1]

Footnote 1 above – This bullet point is not be read as an alternative expression of the clauses (2)(a) and (b) in our revised proposal, which are to be read on their own terms

- 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.

- 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.

# General observations – Limits of 'the rule'

- We consider that our 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.

- We observe, however, that 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.

- If significant market power were to become a deeper or more widespread problem in the spot market, other remedies would need to be explored. In our February 2020 consultation paper (Part D), we agreed with Prof Stephen Littlechild that from a first principle perspective, it is better to deal with potential market power ex-ante rather than ex post, focusing on structure and incentives in designing remedies (new entry, enforced divestment, contracts markets and the like), rather than on conduct.

The observations in this slide are outlined more fully, with relevant authorities, in Part D of MDAG's February 2020 consultation paper.

# Next steps and other matters

# Next steps and questions

- We welcome views from submitters on our revised proposal. This feedback will help to inform our final recommendations to the Authority on a potential code amendment.
- We are aiming to present our recommendations to the Authority Board in December 2020.

Q1. Do you agree that the proposed 'rule' [clause 2] is better than the existing rule, which requires parties to ensure that their "conduct in relation to offers and reserve offers is consistent with a high standard of trading conduct"?

Q2. Do you agree that the economic efficiency framework underpinning the proposed 'rule' is better than the existing HSOTC framework?

Q3. Do you agree that the new preamble [clause 1] is effective in conveying succinctly the intended framework and purpose of the 'rule' [clause 2]?

Q4. Do you agree with clause 3(a), which states when market power becomes significant?

Q5. Overall, do you support the revised proposed code change in preference to the existing high standard of trading conduct provisions?

# Other matters

- MDAG have evaluated various alternatives to the purpose clause seeking to frame the 'rule' and its counterfactual.
- In seeking to improve on the purpose clause in our initial proposal, MDAG developed and carefully considered various iterations of an 'Explanatory Note', which in concept would sit inside the code but outside the code provisions. This had pros and cons, and we consulted with various technical drafting, law and economics experts.
- We concluded that our revised proposal – with the new clauses (1) and (3) – better achieves the policy and drafting objectives.
- 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", MDAG recommended that the Authority should undertake a first-principles review of the Code to make it technology-neutral[1]. If and when that review is undertaken, references to "generators" in our proposed code change should be reviewed to make it technology-neutral as appropriate.

Footnote 1 above: See MDAG Recommendations Paper Enabling Participation of New Generating Technologies in the Wholesale Electricity Market, pg21 at 6.2.5, which states: "the Code should be defined in terms of required outputs and remain neutral as to which technology can best deliver the required output"

# Appendix A: Format of submission

| Submitter | |
|---|---|

| Question |
|---|
| Q1. 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"?<br>**Comment:**<br>Q2. Do you agree that the economic efficiency framework underpinning the proposed 'rule' is better than the existing HSOTC framework?<br>**Comment:**<br>Q3. Do you agree that new preamble [clause 1] is effective in conveying succinctly the intended framework and purpose of the 'rule' [clause 2]?<br>**Comment:**<br>Q4. Do you agree with clause 3(a), which states when market power becomes significant?<br>**Comment:**<br>Q5. Overall, do you support the revised proposed code change in preference to the existing HSOTC provisions? |