27 May 2002

Bill Naik
Chief Advisor
Commerce Commission
PO Box 2351
WELLINGTON

Dear Bill,

TODD ENERGY SUBMISSION ON THE DRAFT DETERMINATION OF THE APPLICATION FOR AUTHORISATION OF THE ELECTRICITY GOVERNANCE BOARD'S PROPOSED ARRANGEMENT.

Thank you for the opportunity to comment on the draft determination document in relation to the EGB's proposed rulebook.

SUMMARY

As stated in our previous submission, our concerns of the proposed new rules relate to three main areas:

1. Single Mandatory Trading Arrangement
2. Governance Structure
3. Transmission

Todd Energy believes that it is critical that these issues are addressed appropriately in the new rules for the proposed structure to be successful.

1) Single Mandatory Trading Arrangement

Todd Energy firmly believes that any arrangement should not create a monopoly structure. The proposed new rules require mandatory participation of all industry players. Further, it removes the present bilateral trading arrangements allowed under the MARIA rules. Thus, the NZEM based trading, pricing and settlement rules and arrangements become a monopoly function. This in turn will lead to inefficiencies since there is no competing trading arrangements.

If participation is voluntary and an alternative arrangement is available to the participants, they will then choose the optimal form of trading mechanism. If one of the trading arrangements imposes a significant cost on the participant, then it is likely the participant will change to the alternative that is less expensive. By doing so, sustained downward pressure is placed on trading arrangement fees.
This is not available in the proposed structure and thus the participant is forced to pay any cost increase due to inefficiencies. As proposed in our previous submission, Todd Energy recommends to the Commission to only authorise the proposed new rules if physical bilateral trading is allowed.

2) Governance

Todd Energy supports the view of many submissions that the governance structure is weighted very heavily towards the large incumbent vertically integrated generator/retailer companies. The view that the industry should be managed by those that make the investment decisions and take the associated risk is correct however this view appears to be narrow in its application i.e. to those making large investments in generation and transmission equipment. The investment by consumers in equipment that runs on electricity (whether it is a commercial refrigerator or a toaster is irrelevant) seems to have been conveniently forgotten. Assuming that retailers who are also generators will act in the best interest of consumers when it comes to voting on issues that may cause some conflict between generators and retailers is naive.

Todd supports the view that the industry is best governed by its participants. The main questions that we have struggled with when reviewing the proposed arrangements are:

- Is there adequate consumer representation through voting rights?
- are the checks and balances within the governance structure adequate to mitigate the risk of pro-competitive rule changes being vetoed by industry participants?

3) Transmission

Transmission and distribution functions are natural monopolies. Todd Energy accepts the Commission's view as stated in its draft determination that under investment in transmission is likely to occur under the proposed new rules. Todd Energy however, disagrees with the Commission's view that there will be inefficient over investment in transmission in the counterfactual of a Crown EGB.

Todd Energy recommends that Transmission issues (Part F) contained within the proposed rule book needs to come under an independent regulatory unit (Regulator).

Attached are comments to specific questions noted in the draft Determination

Yours Sincerely

Charles Teichert
Todd Energy

1. Has the Commission appropriately defined and incorporated the ancillary provisions in its assessment of the proposed arrangements?

2. Are the markets defined by the Commission the appropriate markets for the assessment of the application?

3. Does the wholesale pricing mechanism in the proposed arrangements breach s 30?

   The Commission's draft determination in paragraph 127 is only valid if the proposed rules do not stipulate single mandatory trading arrangement. If single mandatory trading arrangement as proposed in the rules is allowed, each one of the four features identified by the Commission will be breached. Therefore the proposed new rule book will be in breach of s 30.

   As an example, in recent months, one large generator has exercised its market power to the detriment of the consumer. Complaining to NZEM's Market Surveillance Committee did not provide relief as the generator in question was in a dominant position due to transmission constraints. Combined with the constraints, the NZEM pricing arrangements allowed the generator to extract very high price for its generation. ($750/MWh compared to the same generators' $100/MWh price for a station on the same river chain). We will have provide more details on this

   The only available relief to the consumer (purchasers) in the constrained region is to manage demand or increase transmission capacity or local generation. The situation arises mainly because of the price discovery process adopted by NZEM. Allowing bilateral trading helps reduce the dominant position. If however, as proposed in the new rules, physical bilateral trading is prohibited, then the purchasers (consumer) will be adversely affected compared to the present arrangements.

   Todd Energy believes that the pricing mechanism contained within the proposed rulebook is in breach of Section 30. The marginal pricing regime imposed by Transpower and the industry through the NZEM market results in monopoly rentals being collected and distributed to distribution companies. The process of bidding and offering through the proposed rules is competitive, but the fact that prices are altered by marginal pricing algorithms is not and imposes loss of revenue for generators and increased purchase costs for retailers and direct supply customers.
   The arguments for and against marginal losses have been documented in our previous submissions and are currently being reviewed by the industry. It is clear to us that in an industry that is oligopolistic in form and is permeated by transmission constraint and investment issues, marginal pricing is not appropriate for the New Zealand electricity market. The marginal losses issue is directly related to transmission pricing and investment and should remain under the jurisdiction of the Commerce Commission.

4. Does the transmission pricing methodology in the proposed arrangement breach s30.

   Todd Energy supports the view of Meridian in relation to Part F and that Transmission investment and pricing should be regulated by an appropriate body such as the commerce commission. Transmission and pricing (including the

application of marginal losses to energy prices) are issues vital to the competitive nature of the retail and generation markets within the industry.

Todd agrees with other submissions such as Contact, that in recent years there has been under-investment in the national grid. This has been highlighted by the severe and significant constraints in the Taranaki region last year and the recently emerging constraints into the Bay of Plenty region this year. Current incentives on Transpower are not adequate to ensure efficient and effective investment in the grid to minimise constraints and in fact, through the marginal loss regime there is the perverse incentive to withhold investment and maximise line rentals. Part F of the rules provides most of the voting rights to distribution companies and Transpower. Distribution companies are ultimately the recipients of monopoly line rentals that arise from marginal pricing. They to have no incentive to vote for investment in transmission investment that reduces there line rental income that arises from marginal losses.

5. Do the cost allocation provisions in the proposed arrangements fall within the ambit of s 30?

   The cost allocation provisions of the proposed arrangement does fall under and breach section 30. The approval of these rules would place the EGB in the position of negotiating the cost of services for reconciliation, pricing, dispatch, grid security services, registry services, clearing and settlement services, etc. While we agree that some of these services are best performed by one provider (dispatch, grid security and operating services and reconciliation services), some services should still be subject to competition such as clearing, settlement and pricing. A condition that would not be feasible under proposed arrangement.

6. Has the Commission correctly applied the provisions of s 30 to the proposed pricing arrangements?

7. In the absence of the proposed arrangements, would the most likely scenario be likely to include a Crown EGB established under the EAA, with the Guiding Principles contained in the GPS and with operational rules similar to those in the proposed arrangements?

   It is Todd Energy's view that if the Commerce Commission does not approve the proposed arrangements, the most likely scenario would be as follows:
   1) As a result of the current approval process, the Commerce Commission does not approve the proposed arrangement but identifies the areas within the proposal that do not meet the Commissions criteria for approval
   2) The industry changes the proposed arrangement to comply with the commissions requirements and resubmits for approval
   3) Having stated the reasons for not approving the initial proposed arrangement, the commission would find it very difficult to not approve a second proposed so long as it incorporates changes identified by the commission.

   This would in effect allow the EGB to establish an arrangement that meets the minimum requirements of the Commission. Not altogether a satisfactory process but its the most likely scenario.

   As pointed out by Trustpower in their initial submission, the time lag required to set up a crown EGB would give the industry EGB the necessary time to reformulate its

proposal and resubmit to the Commerce Commission for approval. Note that if the process for establishing a crown EGB was initiated, this would further provide incentives for the industry EGB to meet the requirements of the Commission.

8. Would a change to the proposed Guiding Principles so that they were more closely aligned with the principles and objectives in the GPS be likely to enhance competition or otherwise increase consumer welfare?

9. Would the proposed voting arrangements be likely to lessen the likelihood of the implementation of desirable pro-competitive rule changes?
   The nature of the governance structure places the voting power with the large incumbent participants who are of a similar nature – i.e. vertically integrated retailer/generators. Changes to rules such as perhaps relaxing the prudential supervision requirements for purchasers, although never tested, we believe would be met with considerable resistance by the incumbent players. Such a rule change would be pro-competitive on the basis that it would relax one of the major barriers to entry for retailers. It would also increase credit risk (which is currently very minimal) to generators.
   Note that a retailer who is also a generator can offset generation income against expected purchases to reduce credit support requirements; ie a vertically integrated generator/retailer is not required to provide substantial credit support.

   Certain sections of the proposed arrangements also give voting power to particular groups of participants even though the rule changes voted on may have a direct or indirect impact on other classes of participant. An example of this is in Part F regarding transmission pricing and investment. Distribution companies are provided with a substantial proportion of voting rights when transmission related issues impact upon all classes of participant in a significant manner.

   Similar groups of participants voting on rule changes will vote the way which benefits them most. Such voting may not even be a conscious effort but may be a result of a belief that costs shared among all participants is efficient. Such a governance structure will stifle innovation and diversity in the mistaken belief that the current method of performance is best and there is no other more efficient way. The rules will force all participants to act within the industry in a manner similar to all other participants and it will be justified on the basis of efficiency.

10. Under what circumstances would affected parties be likely to have sufficient commonality of interest to vote collectively against recommended pro-competitive rule changes?
    Note the example above regarding prudential supervision requirements. This also applies to clearing and settlement costs and market administration costs. As bilateral physical trading is not available under the proposed arrangement, there is no competitive option on market services.

11. What examples are there in existing NZEM, MACQS and MARIA governance arrangements of pro-competitive rule changes being voted down?
    Mighty River Power recently brought before the industry a proposed rule change which would park marginal loss and constraint rentals in a trust account instead of distributing the monopoly line rentals to distribution company's. It was proposed that a working group should be formulated to consider the best way in which these

rentals should be distributed. This rule change would have been potentially pro-competitive for retailers operating in regions affected significantly by price constraints. This rule change has been delayed and is under consideration by a working group.

Another issue in relation to rule changes is the process for nomination, and appointment of people to working groups. The working groups perform much of the legwork for the industry governance and who is appointed to these working groups is decided by majority vote. Needless to say that the majority of people nominated as well as appointed are from the largest players. Again a process that is susceptible to bias which creates bias in the output of the working groups.

12. What examples are there under NZEM, MACQS and MARIA of pro-competitive rule changes being implemented?

13. What rules in the proposed Rulebook have the potential to be changed in a way that would enhance competition?
    - bilateral trading to allow competition in clearing and settlements services
    - reduction in credit support requirements for purchasers
    - change from marginal loss based pricing to average losses or alternatively, returning monopoly loss and constraint rentals to generators/retailers

14. From the consumer perspective, do the proposed voting arrangements give rise to any concerns, and if so in what areas?
    The knowledge that the representative of a retail customers is most likely to be a vertically integrated generator/retailer, who values plant and machinery many time more than the customers they serve, would not provide any assurance to those customers that they are acting in their best interests.

15. What services would be likely to be provided on a competitive basis under a Crown EGB? How does this situation compare with the proposed arrangements?
    If the Commission does not approve this proposed arrangement or an amended version put forward by the industry then we contend that the Crown EGB would adopt a version of the proposed arrangement amended to reflect the failings the commission identifies.

    90% of the content of the proposed arrangement is based on the existing arrangements of MARIA, MACQS and NZEM which already have a relatively high level of industry buy-in. So it is only logical that a joint governance structure would adopt the work that is 90% workable and adjust the remaining rules that give rise to dissent within the industry and also cause the Commerce Commission to withhold approval.

    We believe that the end result would be a single governance structure with one rulebook that includes the ability for industry participants to trade bilaterally allowing potential competition to arise in the market services and clearing and settlements sector.

16. Would the proposed provisions relating to the pricing of services to non-members result in a lessening of competition compared with the situation in the Commission's counterfactual?

No

17. Would the provisions of Part C of the Rulebook relating to common quality lessen competition compared with the counterfactual?
    No

18. Would the provisions of Part D of the Rulebook relating to metering arrangements lessen competition compared with the counterfactual?
    No

19. Would the provisions of Part E of the Rulebook relating to registry information and customer switching lessen competition compared with the counterfactual?
    No

20. What are the likely differences in ability between an Industry EGB and a Crown EGB to assess pricing methodologies, and what would be the benefits and detriments associated with any differences?
    An EGB appointed by industry or the crown is likely to have little direct knowledge and technical expertise that would enable the board to evaluate transmission and pricing methodologies. The EGB will be made up of persons appointed for their governance ability rather than their depth of knowledge in particular areas of the electricity generation, retail and transmission sectors. The EGB whether it is crown or industry appointed will most likely refer such work-streams to working groups and will rely on their ability to evaluate pricing methodologies. The EGB will always have the ability to question the work of the working groups but at a technical level, the EGB will still be reliant on the output from those work groups.
    The make up of working groups appointed by the crown may be referred back to the industry given the Governments desire for industry involvement in this area. Working Groups appointed under an industry EGB will be decided by industry vote and will be dominated by the large vertically integrated retailer/generator class of participants and distribution companies. This would not change under the counterfactual, except in the case that a pricing methodology cannot be agreed and they commission intervenes.
    The method of appointment of people to working groups under both regimes creates the potential for bias in the output of those working groups. Both the industry and the crown can claim that it has the expertise to evaluate pricing methodologies however there will always be the suggestion of bias, particularly if the working group is appointed by industry and is does not have a wide representation of diverse market participants. Note that the crown is naturally biased as it has a large investment in the industry through the SOE's including Transpower. It is unlikely that the Government will adopt policies and pricing methodologies that put those investments at risk given the crowns natural risk averse nature, not to mention the social policy it may choose to enact through industry reform.

21. If there are any existing pricing inefficiencies relating to the HVDC link, would they be likely to be addressed as effectively by an Industry EGB as by a Crown EGB?
Same process and issues as above.

22. The Commission invites comment on its assessment of the arrangements for pricing and investment decisions under the counterfactual.
Todd Energy agrees with the assessment of the Commission and supports the counterfactual as the best approach to this issue.

23. The Commission invites comment on its assessment of the impacts on transmission investment in the proposed arrangements relative to the counterfactual.
Todd Energy agrees with the assessment of the Commission.

24. The Commission invites comment on its assessment that the transmission pricing methodology is likely to be similar under either governance arrangement.

25. Would the provisions of Part G of the Rulebook relating to trading arrangements lessen competition compared with the counterfactual?
No. Trading arrangements surrounding physical dispatch and the bidding and reoffering system are similar to what occurs under the current arrangements. Bilateral trading is governed by Common Quality Obligations that are very similar to the rules applying to NZEM physical trading.

26. Would the provisions of Part H of the Rulebook relating to clearing and settlement lessen competition compared with the counterfactual?
Yes. The mandatory nature of the trading rules relating to market services (as opposed to dispatch and reconciliation services) would lessen competition compared to a counterfactual which provided for bilateral physical trading such as currently possible under the MARIA rules.

    The Commission has agreed with our previous submission that it is feasible and a public benefit to allow competition to occur in market services sector. Although the bilateral trading rules required to allow this would be located in other sections, the impact in terms of competition would be in the clearing and settlements and administration services provided by the new industry EGB.

    Todd Energy notes that in a review of the gross pool method performed by the MARIA Governance Board, Charles Rivers Associates was commissioned to produce a paper on this subject. The report is available at the following internet address:
    http://www.nzelectricity.co.nz/mrcc/MGBM/010725/CharlesRiverReport.PDF
    This report concludes that bilateral trading rule should be retained in the new arrangement to allow competition in the market services area.

27. Would the provisions of Part I of the Rulebook relating to implementation and transitional issues lessen competition compared with the counterfactual?
Not substantially. Some submissions have been made that object to incumbents receiving a benefit in the form of a transition period to move to the new rules. Although Todd agrees with these submissions, the benefit is small and short-lived and unlikely to have a significant impact on long term competition issues that are of more importance.

28. Notwithstanding the Commission's usual approach of not counting transfers of wealth between one group and another either as a benefit or detriment, having regard to the principles of the GPS which emphasise the wellbeing of consumers, is there a case in this instance for recognising transfers from consumers to producers in this assessment of detriments? If so, what weight should be given to this factor when assessing detriments against benefits?

29. Is the Commission's assessment of the influence that the GPS would have on an Industry EGB relative to a Crown EGB correct?
    Yes

30. To the extent that influence differs, what would be the impact on benefits and detriments?

31. Is the Commission's assessment of the rule and decision-making capabilities of the industry relative to the Minister and Crown EGB correct?
    As noted under Question 20, the people appointed to the governance board by the industry or the crown are unlikely to have a depth of knowledge in all technical areas of the industry. The work performed by the working groups and how those working groups are appointed will determine the quality of information the governance board has to work with and it appears that this structure will be the same under the industry as well as the counterfactual.
    Neither a crown appointed or industry appointed EGB should have an advantage in terms of technical prowess. The ability of the crown EGB could also be affected appointments to the board made on the basis of politics rather than ability.

    Of significance is the fact that a crown appointed entity may be subject to much more intense lobbying as the process becomes more politicised.

    Todd Energy agrees with the assessment of the Commission with respect to the incentives to vote with self-interest and the dominance of large generator/retailers under an industry EGB.

32. Are there other markets where the proposed arrangements are likely to have a material impact on public benefits and detriments?