

(Hearing commences at 9.00 am)

SUBMISSIONS BY ELECTRICITY GOVERNANCE BOARD LIMITED

CHAIR: Ladies and gentlemen I think 9 o'clock having arrived I suggest we get underway. So, first I'd like to welcome you all to this Commission conference which is being held in relation to the Electricity Governance Board's application for authorisation of an arrangement that proposes to restructure and rationalise the basis under which electricity is traded. This, as you know, is proposed to be achieved by combining various existing market arrangements, integrating those into a single rulebook and implementing various supporting agreements.

I am John Belgrave, Chair of the Commission. On my right is Paula Rebstock, the Deputy Chair, Denese Bates QC, a member, Peter Taylor, a member on my right, and Donal Curtin a member, on my far left. Assisting us with this matter are number of staff. There on the right and starting from this end, Bill Naik, Nathan Strong, Dick Adam, Peter Taylor, our legal counsel, Richard Stone, Geoff Thorn and Ben Skelton. Catherine Best I think if she's not here I'd just like to record the work she's done in getting this conference organised. I'm sure things will go smoothly. So, again to welcome everybody. Certainly the Commission appreciates the way in which various parties have interacted with the staff to make the preparation for this meeting.

Just for the record, the applicant's application was registered with the Commission on 7 December last year. We sought clarification of some aspects of the application and this was provided in February of this year. Then following that, initial views were sought of interested parties and as you know the Commission's draft determination was issued on 26 April and the draft determination, as is customary, outlined the Commission's thinking at that time and identified issues on which the Commission sought additional information and views. Written submissions were received from some 23 interested parties. These have been posted on the Commission website, so no doubt you've had a chance to have a look at them.

There have been a couple of recent developments since - again which you'll be aware of - but I'll just refer to them. First in response to a question raised in the draft determination, the applicant has suggested conditions which the Commission could impose if such conditions were necessary for an authorisation. The suggested conditions were provided to the Commission on 6 June and they were forwarded straight away to interested parties. During these hearings we would like the views of parties on the likely impact of the adoption of these conditions on competition and on public benefits and detriments.

But at the same time, I'd like to make it clear the Commission does recognise that some people have expressed concerns that it might be difficult to assess the impact in the time available. We would also welcome comments on that point and overriding the appropriateness of the Commission imposing any conditions on an authorisation, particularly given the time factor as well as the substantive issue.

Secondly, as you'll know, the applicant has sought to extend its application to cover giving effect to the voting arrangements in the rulebook. Again the Commission seeks comment on this request, including the question of whether or not interested parties have had sufficient opportunity to consider the implications of any extension of the application. So, there are two issues there, the substantive issue and also the procedural issue in this instance has been important, on the part of some parties so we'd like to hear views on both of those.

There are a vast array of complex issues raised by the application. Certainly, as I said, the Commission is appreciative of the assistance provided to date. We'll do our best to make our final determination as

1 soon as possible and at this stage we're looking to do so by mid-July.

2 A couple of points on procedures. We've set down some five days
3 for the conference and there is an indicative timetable at the door. I
4 think some of you will have had the timetable in advance anyway. It is
5 proposed that we start with the applicant and then, as far as is
6 practical, given the availability of parties, follow with those who are
7 generally supportive of the application and then those against. The
8 applicant will then of course have the right of reply. The Commission
9 will do its very best to ensure that everybody is given a fair
10 opportunity to present their case and if necessary of course some
11 adjustments can be made to the timetable so that we can ensure this is
12 possible. Whether or not all the days set aside need be full days we'll
13 see as we move along.

14 On the indicative timetable you'll see that we've left vacant the
15 morning of 20 June. That period is now available and the staff will talk
16 to parties to see if there might be some adjustments to the order of
17 appearance so we can make use of that time if people are available. In
18 any event though the applicant may prefer to leave the right of reply
19 date as scheduled, given that they may of course wish to prepare, but
20 again we can discuss that directly. We'll leave the venue open during
21 lunch breaks, there'll be somebody here, so you can leave your papers
22 here. Tea breaks are scheduled, it will probably be useful to have them.
23 A little more on procedure - these conferences for those of you who have
24 been at them before, are designed to allow interested parties to present
25 their arguments to the he Commission and for the Commission to test those
26 arguments by questioning.

27 Under the Act section 64, which required that we provide for as
28 little formality and technicality as possible, I'd like to emphasise that
29 so people don't feel that proceedings have to be unduly formal, so you
30 can make the points you want to.

31 It's not, as is our custom, nor is it intended to be an adversarial
32 proceeding. Cross-examination is not allowed. Although parties will, I
33 hope, be responsive to questioning by the Commission and by staff as
34 appropriate. It's not a public conference in the strict sense of the
35 word. The public is of course welcome to attend, but the public don't
36 have a right to speak or to ask questions. We'll maintain a full record,
37 both by transcription and tape recording and I'd be grateful if persons
38 speaking could speak from the microphone and speak as clearly as
39 precisely as you can, if each speaker could state his or her name and the
40 party they representing, it would help the record taking, and again, I am
41 as guilty as anybody, but it is important to speak reasonably slowly so
42 that our transcripator has some show of picking up what's said.

43 You can be assured that the Commissioners have read all of the
44 submissions carefully and I'm sure more than once, so I think any
45 summaries of submissions should be as succinct as possible. I'd ask
46 presenters to focus on the key issues in their addresses. Again the
47 Commission can consider only those issues within its jurisdiction.
48 Accordingly we would not be looking for submissions on issues which are
49 not directly relevant to the EGBL application. Ideally it would be
50 useful if the conference was able to avoid confidential material, and I
51 think so far none of the parties who have made submissions has sought
52 confidentiality for any of the information provided. However, if it is
53 necessary to consider material which presenters or parties consider is
54 confidential, then we would close the discussion to Commission members
55 and staff and to any legal counsel or experts involved in that
56 submission. But as a matter of general preference, the Commission does
57 look as much as possible for submissions and arguments to be heard in
58 public.

59 So if there are no questions on procedures for the moment, during
60 the conference as I said, if people talk to Bill Naik or Catherine Best,

1 who has now come into in the rear of the room, we'll do our best within
2 the context of where we're trying to get to be, as flexible so people do
3 have opportunity to be heard. I think it goes without saying that the
4 Commission certainly is looking with interest to hearing submissions that
5 will be presented today. Just thank you again for your attendance and
6 perhaps could I ask representatives of EGBL to open the bathing. So,
7 Mr Caygill or Mr Kos.

8 **MR CAYGILL:** Mr Chairman, thank you Mr Chairman, members of the Commission, my
9 name is David Caygill. I've been chairing the Electricity Governance
10 Establishment Committee and as such effectively chair. What I'd like to
11 do is just briefly introduce the people who will appear in support of the
12 application. On my right is Stephen Kos, and on his right James Palmer,
13 who are partners in Russell McVeigh. Stephen will act as our principal
14 advocate in presenting the application and James will assist him in that
15 regard. On James' right is Keiran Murray and Eric Hansen, who are
16 director and consultant respectively in the Law and Commission Consulting
17 Group. LCCG is part of the project team which has worked with the
18 Establishment Committee, and they will speak to portions of the
19 application. On Eric's right is Kirsten Massey, who is also from Russell
20 McVeigh. On my left is Lee Wilson, who's the head of the project team,
21 and Malcolm Alexander, also a member of the project team. Malcolm's the
22 general manager of Market Services at M-Co.

23 At this point what I'd like to do is just to ask Stephen to outline
24 the structure of our application and how we would like to handle it, and
25 then I'd like to say something briefly by way of introduction.

26 **MR KOS:** Thank you Mr Chairman, members of the Commission, good morning. I
27 wonder if you have the applicant's notes for the conference which is a,
28 at first sight, slightly daunting addition to your paper load, but I want
29 to start by assuring you that you'll see that most of it in fact is in
30 the form of exhibit after the yellow divider, and in the earlier section
31 you will see - if we look at the index - that we have identified 19
32 issues which we propose to address during the course of the morning and
33 the afternoon. The first part of the volume consists of a series of
34 speaking notes which summarises essentially the key points we want to
35 address.

36 But we thought it might be helpful to go a bit beyond simply
37 summarising what we wanted to say and so if we look for example at page 8
38 of the document, which takes the first of the issues, the counterfactual
39 issue, you'll see that what we've done is provide - we've done this for
40 each of the issues - a very short summary of the application of the draft
41 determination, a note of the relevant questions, noted what our
42 submission was in relation to the draft determination, noted the
43 supporting submissions supporting the applicant and those opposing the
44 applicant, all in summary form and in each case we provided cross-
45 reference s to those submissions so we know where the relevant parts of
46 those submissions are found. Then the key part, and the part we'll be
47 addressing with the Commission today, is the applicant's response, which
48 is generally found at paragraph 1, 2, 3, whatever it is, point 7 of the
49 document and we'll concentrate on that, that part of the material today.

50 We don't suggest to the Commission that all 19 issues are of equal
51 importance. We've identified for the Commission a number on which we'd
52 like to concentrate, in particular topics 4 and 5 which concern decision-
53 making and pro/anti-competitive rule changes. Topic 7 and 8, which
54 involve transmission under, or over investment competition in
55 transmission services and topic 13, cost of capital and these could be
56 described I suppose in terms of the net benefit detriment analysis as the
57 main money items. So, they'll get more time from us this morning.

58 Some of these topics we will address collectively, some of them I
59 will probably address alone, or James may do so. But all members of the
60 applicant's team before you today are available to ask questions and we

1 look forward to doing so. And with that brief outline of the structure
2 and approach I'll hand back to David to open the case.

3 **MR CAYGILL:** Thank you. What I'd like to do is briefly provide some context for
4 the application. I don't propose to read the introduction that you have
5 in front of you, but I'd like to highlight some elements of it.

6 Today's hearing represents the culmination of some 18 months work
7 on the part of the Establishment Committee, but in many ways I think the
8 origin of the issues that we need to discuss lies even earlier, or has a
9 wider context to it. It's something of a cliché I think almost that the
10 electricity industry has been going through reforms for a long period of
11 time.

12 It's hard in that sense to know what's the most appropriate
13 starting point. But I think probably the most relevant starting point to
14 the context of this application is the introduction of the wholesale
15 market in 1996. Reforms prior to that date focused I think on different
16 objectives - the objective of more appropriate business structures in the
17 corporatisation of ECNZ, or the corporatisation of the power boards and
18 so on, or another bracket of changes related to the introduction of
19 competition in particular parts of the industry, the removal of the
20 franchise areas unique to each power board, or the introduction of deem
21 profiling allowing competition in relation to domestic customers.

22 The introduction of the wholesale market in 1996 was quite
23 different from either of those other reforms, and there are some aspects
24 of the wholesale market from its outset that I think are worth noting at
25 this very early stage.

26 Firstly, the wholesale market has always had only a limited number
27 of participants, reflecting essentially the structure of New Zealand, I
28 suppose, in some ways, but certainly its electricity industry. Secondly,
29 and this may perhaps be unique to New Zealand, I'm not sure, in any event
30 it's clearly unusual, New Zealand's wholesale market has been based from
31 the outset on a multi-lateral contract, amongst, between participants in
32 the industry.

33 Although the Government was involved in its creation, it was not
34 created by the Government. It's not in that sense a species of
35 regulation.

36 Thirdly I think it's worth observing it may be relevant to some
37 later discussion, that although NZEM, (the New Zealand Electricity
38 Market) the agreement that established the wholesale market was a
39 voluntary arrangement, it has never stood on its own. It has practical
40 links through to MARIA, the reconciliation information agreement, and
41 more latterly through to MACQS, the Multi-Lateral Agreement on Common
42 Quality Services. What the wholesale market does of course is matches
43 supply and demand for electricity, every half hour, at 244 different
44 points on the transmission system. That's in some way still, I think, an
45 extraordinary achievement. Many wholesale markets still don't have nodal
46 pricing internationally. More importantly, I think it's worth noting
47 this is still a relatively novel set of arrangements. They've been in
48 place a number of years, but only a small number of years. The
49 arrangements are flexible, have in fact been amended considerably in the
50 last six years. We'll come back to the importance of that point later,
51 being a multi-lateral private contract, were based and are based on the
52 parties' perceptions of their own interests as well as their perception
53 of the common interest, were done importantly at the Government's behest.
54 The Government was involved in the establishment of something called the
55 Wholesale Electricity Market Development Group which led, after a not
56 dissimilar period of time, to this exercise to NZEM.

57 Fourthly, I think it's worth noting that these arrangements of
58 their nature contain incentives to minimise costs. Those are the
59 arrangements in essence that were established in 1996, only three years
60 later, and following the change of Government, an inquiry was held into

1 the electricity industry generally. I had the privilege of chairing that
2 inquiry. It had wide ranging terms of reference and almost 500,477
3 submissions were lodged in response to it. Those facts are relevant I
4 believe because it is significant that in an environment where the
5 wholesale market had been established only a few years previously and the
6 terms of reference were wide. The industry and public interest
7 organisations came to the inquiry and could say virtually anything they
8 liked, and in essence said two main things.

9 There were two main themes that came out of the inquiry. One had
10 to do with the need for, appropriateness of control of prices in relation
11 to the distribution sector, the lines companies. I don't believe that
12 aspect of the inquiry's work is directly relevant to the matters we need
13 to talk about today.

14 But the second main theme which emerged in the inquiry I believe is
15 relevant. A considerable number of submissions identified improvements
16 of one kind or another to the wholesale market which submitters believed
17 should occur. And that group of submissions in turn identified two areas
18 of common ground.

19 Firstly, a number of people commented, or acknowledged in what they
20 said, that even at that time efforts were underway to rationalise the
21 arrangements in respect of the wholesale market. By then the first few
22 months of the year 2000 there were three industry agreements, NZEM, MARIA
23 and MACQS, and work was underway to amalgamate NZEM and MARIA with a view
24 to subsequently linking MACQS into what was then to be called NZEX.

25 The second main theme which emerged from the submissions relating
26 to the wholesale market was the lack of an adequate framework or set of
27 rules in relation to transmission. One way I believe our present
28 arrangements might be characterised is that we have by international
29 standards a very efficient arrangement for calculating the price of
30 energy, electricity - every half hour, 244 different places. But we do
31 not have satisfactory arrangements, almost of any kind, in relation to
32 calculating transmission costs, or determining appropriate transmission
33 investment, and that led to a set of recommendations of the inquiry which
34 in turn were picked up by the Government in its response to the inquiry
35 which emerged first, in the form of a draft policy statement in June 2000
36 and then - sorry the inquiry reported in June, the draft policy statement
37 was a couple of months later. Then its final policy statement after the
38 Government had consulted on its draft was released in December 2000.

39 Although the policy statement followed, I should say gratifyingly
40 closely, the recommendations of the inquiry, I'd like to draw the
41 Commission's attention to one small but I think significant difference,
42 in relation to an important issue. The inquiry had recommended that the
43 electricity industry be given the opportunity to put in place self
44 governing arrangements, a revised multi-lateral contract. What the
45 Government policy statement said was indeed the industry should have that
46 opportunity, but more the Government expressed a positive preference for
47 that as an outcome. The Minister said on behalf of the Government that
48 it was the Government's wish to see this happen, and if it couldn't, or
49 couldn't on satisfactory terms, then in that event the Government would
50 contemplate regulating.

51 Of course at the same time as the Government released that policy
52 statement, it introduced into Parliament a piece of legislation which
53 ultimately became the Electricity Amendment Act 2001 which provides both
54 the framework, or the powers to establish an Electricity Governance Board
55 appointed by the Government. If I might say so, I think the terminology
56 the Commission has adopted in its draft determination of referring to a
57 Crown EGB as distinct from an industry governance board is particularly
58 helpful. We'll go on using that nomenclature, if we might, so as to
59 avoid confusion between two bodies with the same name. It's important to
60 acknowledge I believe that while the Electricity Amendment Act provides

1 the powers for the Government to establish what we might call a Crown
2 EGB, it also provides the powers for interacting with an industry body,
3 in a number of ways which actually could, if there were a need for this,
4 be operating now.

5 If one looks at the powers in the Electricity Amendment Act,
6 there's no particular reason why one couldn't designate either NZEM or
7 MARIA or MACQS, or all of them, as electricity governance organisations,
8 each of them has a governance role or has governing bodies with a
9 governance role.

10 I'm not aware of whether any particular consideration has been
11 given to doing that. It's not a matter that's been canvassed so far as
12 I've heard by the Government. So, I can therefore only surmise that
13 there are possibly a couple of reasons why that hasn't happened, but I
14 think it may be useful to make these suggestions. Firstly, it's been
15 apparent to the Government that all three existing bodies have been
16 working since the Government policy statement to put a new set of
17 arrangements in place. Apparent because they've said so, apparent
18 because they've interacted regularly with the Government about that
19 objective.

20 The second reason one might usefully avert to I believe, is that in
21 the discussions that the three bodies and indeed the Establishment
22 Committee has had with the Government, a dialogue has emerged not unlike
23 the arrangements that would have occurred had the Electricity Amendment
24 Act formally been used. In other words, the Minister has from time-to-
25 time said to the industry, "I am interested in these outcomes". What can
26 you do to put in place arrangements for example that, whereby the
27 industry would disclose the amount of water spilled from hydro-stations
28 on a common basis. The industry has said yes, we can do that, let's go
29 away and devise some rules. That's been done. It's not part of the
30 present application, but it's been done since we lodged the application.
31 But it's a good example of the Minister specifying an outcome and the
32 industry responding, which is precisely the mechanism contemplated in
33 sub-part 2, of part 15 of the Act.

34 I wanted to outline - and indeed there have been other examples as
35 well and we've referred to them. I wanted to outline that process
36 because I believe it's very important to see that neither under the
37 regime contemplated by the Electricity Act, nor in fact at the present
38 time is it the case that self-regulation amounts to the industry simply
39 doing whatever it feels like without any engagement with the Government
40 or a regulatory framework. On the contrary I believe a better way of
41 thinking about what we might mean by self-regulation, or indeed how the
42 arrangements that are in front of you in the application might work in
43 practice, is they will set up a tension between industry self-interest
44 and Government oversight. Both elements will be in play in some state of
45 tension under these arrangements as in fact they are now.

46 Lastly, I hope it might be useful if I briefly said something about
47 the processes that the Establishment Committee has used. The
48 Establishment Committee has constituted at the end of 2000, following the
49 Government policy statement, as the Government policy statement
50 contemplated. We operated through three working groups, one dealt with
51 issues of governance, the new arrangements contemplated in the policy
52 statement in relation to governance.

53 The second dealt with the need to rationalise the three existing
54 industry agreements, and the third working group dealt with the issues of
55 transmission - the transport side of the industry if you like - the new
56 area of design contemplated by the policy statement.

57 Importantly perhaps, the Establishment Committee from the outset
58 explicitly adopted what we called a base line approach. That's to say we
59 saw the immediate need in response to the policy statement to be - to
60 rationalise the three existing agreements as far as possible as they

1 stood. The most obvious exception to that approach being the need to
2 write new rules in relation to transmission. In other words, explicitly
3 in our mind from the outset, has been the thought that these rules would
4 need to evolve, not merely as circumstances change, but also in response
5 to perceived improvements that could be made to the rulebook in a number
6 of directions, pretty much immediately. But we felt that if we began
7 with a slightly different question, where might the current arrangements
8 be improved, that would prove a very much larger exercise which would
9 delay the achievement of a set of arrangements which conformed to the
10 Government policy statement and provided a basis for subsequent
11 improvement.

12 The rules in front of you have been the subject of intensive
13 consultation. In particular, in two formal rounds of consultation in the
14 middle of last year and then again in September/October last year, before
15 the application was lodged in December.

16 I've struggled somewhat to think of the best most useful way of
17 characterising what's in front of you and I suggest that they can be
18 viewed as a consensus that is not any more than any recommendations in
19 the inquiry were the views of, the position of any one member of the
20 industry, rather I believe they're a consensus which is likely to command
21 more support, at this point in time, than any other set of arrangements
22 which would be consistent with the guiding principles proposed in the
23 Government policy statement.

24 Now that we've got that far, we've placed this rulebook in front of
25 you so that you may determine whether the proposed arrangements are
26 lawful, conform to the Commerce Act. If they're found to be lawful in
27 that sense, then they will be put to a vote, as the rules themselves
28 provide, for the approval of the industry.

29 I should acknowledge, so that there's no misunderstanding, before
30 that referendum, it is entirely likely that a number of further
31 amendments will need to be made to the rulebook to accommodate, in
32 particular, changes that have been going on within the three codes since
33 we lodged the application. Also to pick up some of the issues that we
34 have continued to work in the meantime with the Minister. I gave earlier
35 the example of hydro spill disclosure. It's kind of a difficult question
36 of when the music stops and when you sort of all try and find chairs and
37 say well, you know that's it, you know, we'll now take a picture or
38 whatever. The analogy's an awful one, but hopefully you know what I
39 mean.

40 It has simply not been practical for us to try and work in what you
41 might think of perhaps as the other way, of getting complete agreement,
42 assuming that were possible, freezing existing arrangements which are in
43 real time as it were, actually behind the fact that the lights are on
44 this morning and the system is operating. Instead, we've tried to focus
45 in the design work so far on all the elements which might raise
46 competition issues. All the elements which would clearly require to be
47 authorised, assuming that issues like information about hydro spill don't
48 obviously raise competition issues and therefore might be able to be
49 added.

50 The question of what we can and cannot do by way of subsequent
51 amendment will need to be considered in the light of the Commission's
52 authorisation, not a matter about which we made any pre-judgment, simply
53 assuming that there may be some room to move within the confines of any
54 authorisation.

55 So we ask you to look at what we've placed in front of you. You
56 make your decision in relation to that. We then consider whether there
57 is room to add further refinements, NZEM's work on bids and offers for
58 example is another instance. We hold a referendum as the rules provide,
59 to determine whether there is a substantial majority of the industry
60 supportive of these arrangements, that's the language in the rules. Then

1 lastly, a number of parties need to determine whether they are in a
2 position to support the new approved rulebook. Importantly the system
3 operator, the three existing codes, each of whom would need to wind up,
4 and the Establishment Committee itself.

5 Assuming all those ducks line up, we would then have a set of
6 arrangements that we can bring into force. Possibly that transition
7 sounds as complicated as some of the rules themselves. We've - each of
8 those elements exists for a reason which has seemed sufficient and as a
9 whole workable, and all I think I can do at this point is commend the
10 rulebook to you and indicate I'm very happy to respond to any questions
11 you may have at any stage about the application. Thank you.

12 **CHAIR:** Thank you Mr Caygill, and for taking us through the particular points
13 of the application. Just before I ask you Mr Kos I wonder if any
14 Commission members have any questions.

15 **MS REBSTOCK:** I just wouldn't mind going back to some of the points that you
16 made Mr Caygill and ask you a few questions. I'm quite interested in
17 your view, having been chairman of the organisation. I won't take them
18 in the order actually that you said them, but - so you'll have to bear
19 with me just a bit. But when the - after the inquiry and when this
20 process got underway, did you set down what you would be aiming to
21 achieve in terms of the degree of agreement within the industry in order
22 to proceed?

23 **MR CAYGILL:** In a general sense I believe we did, perhaps not explicitly at that
24 point. I have tried in chairing the meetings of the Establishment
25 Committee to make sure that we have what I guess I tend to think of as
26 sufficient support at each stage. It's my custom to try and sense
27 whether, even groups who may be uncomfortable with a particular decision
28 and nevertheless sufficiently comfortable that they were heard, or
29 comfortable that the process might - should still proceed. In the
30 initial stage, first of all we've taken the Government policy statement
31 as the fundamental guideline. So, in one sense that's a framework. Have
32 we got something which conforms to that? Rather than starting with a
33 blank sheet of paper.

34 Secondly, we were aiming initially for something on which we were
35 sufficiently agreed that could be the basis of consultation with the
36 industry. We're not seeking to design a perfect set of arrangements, we
37 were seeking to design something that we were comfortable taking out for
38 consultation, so that response would tell us whether we were heading in
39 the right direction. The principal thing that, in retrospect strikes me
40 that came out of the first round of consultation was people wanted a
41 second round of consultation. They wanted to see what changes were made
42 in the light of what they had said. Seemed reasonable. We produced a
43 second round of consultation, and from those consultation mechanisms
44 emerged clear themes about the issues which were problematic and the
45 issues which were essentially not. There has been disagreement about a
46 number of issues as part of the process. It's never looked as though
47 that could be avoided, as though taking another year would essentially
48 iron out and remove fundamental differences of view.

49 Quite some distance through the process, as we thought specifically
50 about the mechanisms that should be built in around a transition, what
51 thresholds should we set to bring these arrangements into force in place
52 of the existing arrangements? We devised the rule that I referred to
53 whereby we would have a referendum, there would be a formal vote and we
54 would set the threshold of a substantial majority of potential
55 participants. People will not have made the decision to join the
56 arrangements at that place, they will be entitled to vote on the basis
57 that they would, should they choose, be able to exercise that right of
58 membership. So we would get people the rights to vote, even though they
59 had not yet made a decision to enter.

60 That's a pretty high threshold. We chose that. There was quite a

1 bit of discussion around the appropriateness of that, as a way of saying,
2 all right, we haven't been able to get unanimity about each element of
3 the design, so let's now finally give people the opportunity to say yes
4 or no before the arrangements proceed.

5 **MS REBSTOCK:** Just, I don't want to put words into your mouth so please tell me
6 if I've got this wrong. When you talked about the process in the
7 beginning, the way you thought about it, a lot of it was about procedural
8 fairness.

9 **MR CAYGILL:** Yes.

10 **MS REBSTOCK:** Giving people the opportunity to be heard. I guess you know what
11 I'm interested in, and it's what sort of threshold did you have in mind
12 in terms of the substantive agreements that you were trying to reach.

13 **MR CAYGILL:** I think - I find it - I think I understand the essence of your
14 question. If my answer sounds like I'm focusing on processes and not
15 substance then please haul me back and don't take that amiss. We were
16 conscious that we were not starting with a blank sheet of paper. We're
17 starting with arrangements that exist now, seemed to work in the sense
18 that the system does deliver electricity and importantly, shouldn't be so
19 disrupting that that stops, even temporarily.

20 Next, much of the design in the sense of fundamental principles and
21 objectives was a given. Pointless for us to design something that didn't
22 conform to the Government policy statement. All that would ensure was
23 that the Government regulated because we had failed to meet the design
24 requirements. The industry, in my view, made a critical decision right
25 at the very outset, implicit if not explicit in the decision to set up
26 the Establishment Committee.

27 Its decision was that it was sufficiently comfortable with that
28 policy statement to respond positively to it. That decision was not made
29 lightly and it was not made implicitly, it was not quite explicitly by a
30 number of people who came together informally and said do we want to
31 agree or not, yes, we do, well fine, within those design parameters, some
32 quite explicit. There must be an independent governance board and so on,
33 there must be a transmission, set of transmission rules that produce a
34 pricing methodology in this kind of way, very explicit in relation to
35 some of that detail.

36 We were then looking for the solutions that, on the one hand, made
37 the least change to the existing arrangements, so that they could be
38 expeditiously rationalised, or where some other choice was required, some
39 rules simply conflicted, you couldn't have both, you had to make a choice
40 between them or a third choice, then the kinds of guiding principles that
41 exist both within the three codes and in their own right in this rulebook
42 from the Government policy statement, came into operation.

43 What is the most efficient design solution, what is the solution
44 that is most in conformity with the various principles? We took those
45 principles as our design principles explicitly at the outset, said we
46 want design solutions, we want rules, that conform to those arrangements.
47 But where there are choices, we have erred on rationalising the existing
48 base line, rather than some kind of blue skies arrangement in order to
49 act expeditiously.

50 **MS REBSTOCK:** Can I just follow-up with a few questions. At the beginning of
51 your presentation you called our attention to the fact that the market
52 has always been one with a limited number of players and that's clearly
53 obvious. It does strike me that you were making the point quite
54 intentionally and, in a market where you have limited players and where
55 the Government is indicating a preference for self-regulation. Do you
56 think it's fair to say that even though there's limited players, the
57 Government sees that there's enough tension between those players because
58 of their respective roles, that you can get a reasonable balance of - a
59 reasonable balance in terms of self governance from the interplay of
60 those interests.

1 **MR CAYGILL:** I can't obviously speak for the Government but I interpret their
2 policy statement as either implying that, or being based on that
3 assumption. Moreover, I would add, I discerned from what was said to the
4 electricity inquiry, that that view or conclusion is widely shared
5 amongst the industry, but I mean the industry in the widest sense. I
6 think at the margin people are sometimes skeptical about whether
7 particular rules operate fairly as between all interests, or not. I
8 wanted to make that obvious point at the outset, partly because I don't
9 think it's helpful to imagine that we could have a set of rules which
10 would work perfectly if we had a very different kind of industry or were
11 in another country, and partly for the very point that you've
12 acknowledged explicitly, and that is, there is a widespread acceptance of
13 that, or assumption of it, which we might challenge at the margin, but is
14 fundamental to the nature what have we're dealing with here.

15 **MS REBSTOCK:** Can I just take that one further step then. If we were to accept
16 the premise that for self-regulation to work in this industry, you do
17 need a healthy tension between the parties within the industry, the
18 different sectors, presumably it's one of the dynamics that leads to
19 meeting some of the Government objectives in terms of the benefits to all
20 consumers.

21 **MR CAYGILL:** Yes.

22 **MS REBSTOCK:** So does that tell you anything about what sort of consensus you
23 need? In other words, can you assume that you can achieve that healthy
24 tension between the different sectors if the support for the proposal
25 comes primarily within one or several of the sectors but there are whole
26 sectors that feel the proposal doesn't meet the requirements for an
27 authorisation. Does that aspect concern you? If you accept that there's
28 that element not - while consensus doesn't require unanimous support,
29 where there is the greatest consensus, it's not spread eventually across
30 the different sectors within this industry. It seems - does that concern
31 you?

32 **MR CAYGILL:** Yes, but I think it concerns me mainly in this way. I think it's
33 important that we think well and correctly about this issue or set of
34 issues. Firstly, we're not starting with a blank sheet of paper. We
35 weren't charged - the industry wasn't charged by the Government policy
36 statement with developing a set of arrangements that were as far as
37 possible accepted by everyone who might have a legitimate interest in
38 them. There's no design criteria of that kind. Not I think because the
39 Government wouldn't have cared for, or been interested in consensus for
40 its own sake, but simply because we're not starting from - that isn't the
41 nature of the arrangement. We're starting with a given industry with
42 actually a given set of governance at the moment, a number of problems
43 identified by the inquiry and indeed by the Government itself, which the
44 Government was keen to see addressed in certain quite specific ways.
45 Now, with those parameters, it seems sensible, but again not required to
46 look for as much consensus as you could, consistent with.

47 But let me make one other point that I think is important. There
48 is I suggest only one alternative here and it's the counterfactual
49 identified by the Commission. I think what the Commission has said in
50 its draft determination about the benchmark against which we should
51 measure this proposal is absolutely right, and there is no evidence I
52 know of that there would be a greater consensus in favour of either the
53 establishment, of a Crown body, or what might emerge from it, indeed
54 while it might operate according to rules of procedural fairness it
55 wouldn't necessarily be any more interested than any Crown entity is in
56 achieving consensus per se.

57 I think the fundamental issue here is we're concerned at a set of
58 rules which encourage competition, where they can and do acquiesce to its
59 impossibility, where the nature of the issues requires that, there's
60 nothing in that process that says oh, and by the way, see if you can get

1 a consensus in favour of the rules. It's not a bad thing but it's just
2 not an explicit part of the process. We chose to look for that as far as
3 we could and I described the rules in that way because that is how I
4 think of them but it wasn't and indeed I would go so far as to say
5 arguably shouldn't be, an explicit criterion, even in our minds or with
6 respect the Commission's.

7 **MS REBSTOCK:** I just - I mean I came to the point of consensus because that was
8 how you chose to describe what had come out of the process, so that's why
9 I pursued that.

10 **MR CAYGILL:** Yes, I'm sorry, and I pick it up partly because I'm conscious that
11 a number of objections have in effect said we disagree and on that
12 account you know these arrangements shouldn't be approved. I don't want
13 to be unfair to other people, they'll make their own case, but it seems
14 to me that's in some cases pretty close to what's being argued. With
15 great respect, that's almost at a certain point not relevant to the
16 nature of the issues that we have been grappling with, or you now have in
17 front of you.

18 **MS REBSTOCK:** I guess the point I was trying to get your view on was whether,
19 nevertheless the interplay of interests and tension between the different
20 sectors hopefully creates some competitive pressure that leads to
21 positive results for consumers. It's that aspect that I really - rather
22 than, you know, this issue about some parties saying they don't agree,
23 therefore it shouldn't be authorised. It's more the importance of that
24 to this - the functioning of a self regulating body such as what's being
25 proposed.

26 **MR CAYGILL:** I think that is right and I think the most obvious example of that
27 comes immediately to my mind is the function performed by an independent
28 board. Much has been said about and will be said no doubt about the
29 powers of the board. It doesn't get to finally write the rules in its
30 own right, but it isn't on that account powerless; and being independent,
31 sitting to that extent outside the industry, I believe will set up a
32 tension with the industry. Would it be completely oblivious to what was
33 being said by consumer groups? I cannot imagine that will be the case.
34 That's a tension that arguably is not present at the moment and one that
35 the Establishment Committee I think was quite conscious of in our design
36 work.

37 **MS REBSTOCK:** Can I just ask you one question, I'm sure we'll come back to this
38 but I'd like to ask you as chairman, did you envision that the board
39 would not have final decision-making powers in this set up? I mean, when
40 did that feature of the arrangement come about? Was that always part of
41 the proposal from the beginning?

42 **MR CAYGILL:** I think I can say straight-forwardly yes. It was a matter that I
43 recall discussing early with, I don't think it's unreasonable for me to
44 say this, with the Minister and with officials. Not because their
45 consent was essential, but because I wanted them to understand at an
46 early stage, that that was in the minds of the Establishment Committee,
47 and there shouldn't be any misunderstanding about that, if there was
48 going to be a problem about it then, you know, then it's no. So, it was
49 not a design feature - the relevance of that exchange is just to identify
50 the timing. It was not a design feature that emerged late. It was a
51 design feature that emerged early. I think the fundamental reason for
52 that, both the reason it came out early and the sharpest light I can
53 shine on the issue, I've seen this much like the powers of a corporate
54 board vis-a-vis its shareholders. A corporate board may often take the
55 initiative in proposing amendments to a company constitution, but I know
56 of no company where the board in, and of itself, gets to say this rule
57 isn't satisfactory any longer, we will now have the following different
58 rule. That is fundamentally a right that shareholders have.

59 If I could put it in the form of a rhetorical question, who would
60 join arrangements, the nature of which could be changed, without any

1 capacity on their part to say yay or nay?

2 **MS REBSTOCK:** Does it surprise you how many of the retailers in their
3 submissions suggested that changing to the voting structure might be
4 appropriate?

5 **MR CAYGILL:** No, but with respect I think the question of how votes are
6 allocated is a very different question from whether the board --

7 **MS REBSTOCK:** Sorry I misstated that. A number of them suggested that
8 conditions could be considered that would give final decision rights to
9 the board under particular circumstances.

10 **MR CAYGILL:** Yes. That is - it doesn't surprise me at all. That's an issue
11 that we have debated long and on a large number of occasions and the
12 result is in front of you. I believe there's nothing in the Government
13 policy statement which requires or even suggests that a board charged
14 with the governance of industry arrangements should have final authority
15 over the rules. With that the Government's view, I can say I'm confident
16 we would have known that early in the process. In fact that's never been
17 said at any point. Just as importantly I think that, of course, is not
18 the case in respect of any of the arrangements at the moment. In none of
19 the arrangements, not NZEM not MARIA not MACQS, did the governing bodies
20 have final say over the rule. There are different voting arrangements,
21 you know, there are arrangements for example under MACQS where consumers
22 have significant voting rights, but the governing body does not get to
23 alter those rules. That would be a radically different approach and
24 something which - I don't want to start expressing personal views here, I
25 don't think it's appropriate, but I believe the industry would say, would
26 yield much less predictable outcomes if you as a Commission had to
27 evaluate a set of arrangements where an independent board could
28 ultimately change the nature of the arrangements. I don't know what - I
29 struggle with the question, how you would evaluate where that would be
30 likely to head. You can't - there's no tension there between industry
31 self-interest and some other set of principles. An independent board's
32 not governed by - you've lost the tension that I believe lies at the
33 heart of our arrangements and properly exists in the arrangements that
34 are contemplated.

35 **MS REBSTOCK:** Can I just ask one last question and then I'll leave them for
36 further. One of the key policy objectives that the Government has
37 indicated, there's a whole list of things, efficient, fair,
38 environmentally sustainable provision, with an emphasis in the end on all
39 of these things, to all classes of consumers, what - how does this
40 arrangement meet the requirement to provide those benefits to end
41 consumers? What do you think the key dynamics of this, is that allows an
42 industry controlled and driven process to yield those benefits to
43 consumers?

44 **MR CAYGILL:** I believe the key dynamics are two. Firstly, that it is ultimately
45 in the industry's interests to deliver outcomes which are efficient in
46 the sense of being in the consumer's interests, as much as they're
47 efficient as being in the producer's interests. And fair, in the
48 perception of consumers as well, in the same sense that that is true of
49 any industry. The difference here is not in, you start with a different
50 set of motives, or you start with a different set of operating
51 objectives. The only difference here is in the nature of the industry,
52 the structure, the degree of competition, but the second dynamic is that
53 there's no box around this industry. What it does is not secret. On the
54 contrary, what it does is very public. We have a wholesale market that's
55 been going for barely six years and a public inquiry after three years,
56 two sets of policy statements in less than two years, the second is a
57 minor amendment but it arises out of a review of what happened during
58 winter last year.

59 This is an industry which is examined publicly, seemingly every few
60 months. The arrangements under which the industry would operate as a

1 matter of statute law provide an explicit framework where the Government
2 gets to specify objectives and the Government body is obliged to
3 negotiate performance targets and so forth. So there's no reason to
4 think this industry will be any less motivated by perceptions of interest
5 which value customer preferences and it does so in an environment that
6 explicitly provides for public supervision and scrutiny.

7 **MS REBSTOCK:** I almost hear you saying that the industry inherently will move to
8 pursue these objectives. Just because it's like any other industry. But
9 if it were, we wouldn't need these arrangements.

10 **MR CAYGILL:** I think what's different about the electricity industry that
11 requires these arrangements is that it's of the nature of the product
12 that what one person does affects others. This is a product that you
13 can't consume discretely. I'm not putting that very well. But it's
14 literally the case that if consumers in Wellington turn off their
15 electricity appliances, for example because a sports match has finished
16 in the evening, their individual actions affect the system as a whole.
17 When a plant in south of Auckland loses one of its turbines, the voltage
18 changes in the South Island, changes in the whole of the North Island but
19 changes in the South Island as well.

20 This is an industry that needs a set of rules about how power is
21 transmitted, how it's priced, how it's managed, because those things are
22 interconnected in a way that's not true of how plastics is produced, or
23 clothing is produced or - they can be governed by a whole series of
24 private contracts that can differ dramatically from each other, even if
25 there are industry standards that emerged, but efficient outcomes can be
26 produced without multi-lateral arrangements.

27 The multi-lateral arrangement that was put in place in 1996 was in
28 one sense sponsored by the Government, because it believed that a
29 wholesale market would be more efficient than not to have a wholesale
30 market. But it was put in place as a private contract, because it is the
31 case whether the Government maintains this or not, that the industry
32 participants are affected by each other's behaviour. It was therefore in
33 their interests to negotiate something.

34 The only thing that marks New Zealand from the other countries is
35 we're possibly small enough to be able to negotiate this in a private
36 arrangement, whereas in California or the East Coast of the United States
37 or England, there's just too much parties to be able to contemplate
38 getting around a table and negotiating a private arrangement. A market
39 really can't be organised in that way.

40 But, why you need arrangements of this kind at all, has to do with
41 the nature - I didn't in a former life much care for arguments that began
42 on a premise this product is unique, but I've come to the conclusion that
43 there are some features of the electricity system which are - the
44 interconnectedness, the way in which one customer or producer's behaviour
45 affects another's, that this is an industry which, even if the Government
46 said we no longer care, sort this out amongst yourselves, would want,
47 would require common rules. Now what the Government is saying yes, we'd
48 like you to have some common rules, we'd like you to devise them not us,
49 they'll be likely to be more sensible and more appropriate if you do
50 that. However, we will be watching what you're doing. You won't be on
51 your own, we will be regularly setting the targets that we want you to
52 work to.

53 **MS REBSTOCK:** Thanks.

54 **MS BATES:** I'm just going to pick up on some of Ms Rebstock's line of
55 questioning. You told us in your introduction about the 500 odd
56 submissions that you'd got at the inquiry, am I right.

57 **MR CAYGILL:** 477 if I remember the figure correctly, of that order, yes.
58 Somebody must have been counting.

59 **MS BATES:** And then you summarised for us what you considered to be the main
60 themes emerging.

- 1 **MR CAYGILL:** Yes.
- 2 **MS BATES:** I wanted to ask you about the proportion of submissions that came
3 from groups with a consumer interest, just roughly speaking, and whether
4 you could summarise for us what the main concerns of those groups
5 appeared to be.
- 6 **MR CAYGILL:** I'd find it difficult at this juncture to put a proportion.
7 Consumer groups were well represented, both individuals and organised
8 groups. They were particularly interested, of course, in the other issue
9 to do with - that was explicitly raised, the terms of reference to do
10 with whether lines companies needed to be put under price control, and if
11 so what were appropriate arrangements. I don't want to go into that, not
12 least because it's an issue I know the Commission is now seized of.
- 13 **MS BATES:** I'm actually wanting you to focus on the other main issue you
14 identified, which was the wholesale market and what their concerns might
15 have been in relation to that.
- 16 **MR CAYGILL:** There were - the only issue that - the one set of issues that I
17 haven't already referred to that were perhaps distinctive. There were a
18 set of concerns around the ease with which, for want of a better word,
19 the demand side can interact with the wholesale market. Beyond the
20 transmission questions that I mentioned, and I don't recollect that too
21 many consumer groups were overly concerned about that, some of the larger
22 consumers perhaps but not the smaller consumers, there were a set of
23 issues around the ease with which the demand side can interact with the
24 market. Now that's leading into discussions around questions like would
25 we be better if this was an ex-anti market not an ex-post market in terms
26 of the way the price discovery works and so on.
- 27 **MS BATES:** What were they in broad terms? What were they wanting in this
28 regard?
- 29 **MR CAYGILL:** For it to be easier for, either for consumers to know in advance
30 what the prices definitively were. If I give you an example. Comalco
31 came towards the end of the inquiry and made a very interesting
32 submission around the accuracy of the forecast mechanism in the market.
33 We said, well that's very interesting, have you got some facts and
34 figures on that, and they said well, yes and we asked for them and there
35 was a timing problem and ultimately they're not reflected in the
36 Commission's report, but what I would say about that set of issues is
37 that they raised some very difficult - I freely concede personally
38 taxing, challenging questions of understanding exactly how the market
39 works at the moment, and more importantly how it might conceivably work
40 differently.
- 41 I am aware, the Establishment Committee, now putting that hat on if
42 I might for a moment, has been aware that NZEM has been looking at a
43 number of those sorts of issues for some time, but more particularly over
44 the last year. They are a good example of the kinds of changes that one
45 might contemplate being made in future, under the arrangements that we
46 have in front of you.
- 47 **MS BATES:** Were they also concerned with the - having direct representation on
48 the final board?
- 49 **MR CAYGILL:** Back at the inquiry, that's - there wasn't much discussion at the
50 inquiry about precise design of governance arrangements. People were
51 back a stage. They were more inclined to say the arrangements are more
52 complicated than they need to be. We know there is efforts underway to
53 merge the arrangements, that's a good thing and it ought to happen, some
54 people did say. We think that the arrangements in respect of MACQS, the
55 governance arrangements in respect of MACQS, the Grid Security Committee,
56 being its governing body is a better designed model than the governing
57 bodies of NZEM or MARIA, and the distinction there is that MACQS - that
58 the Grid Security Committee has a representational structure, consumers
59 are directly represented.
- 60 That was a reasonably novel structure then. It was only agreed at

1 the end of 1999 the inquiry was taking place the next year. Certainly
2 the Establishment Committee spent some time in its governance working
3 group discussing the wisdom of having a representational structure and
4 for a variety of reasons I'd be happy to go into, or for someone else to
5 address, we could I think explain the governance working group's thinking
6 in ultimately making different recommendations.

7 **MS BATES:** We may come back to that. We're looking at introductory matters at
8 the moment.

9 **MR CAYGILL:** That's fine. The inquiry didn't get much beyond the wisdom of
10 merger, the desirability of rationalisation. The Establishment
11 Committee, if I might just go back to the consumer demand side issues,
12 saw that bracket of difficult challenging issues being a good example of
13 something that we were better to leave to an independent board to
14 address, rather than trying to embark on ourselves.

15 **MS BATES:** I'm asking these questions, I'll tell you why, because when you look
16 at the Government policy statement, I might be putting it a bit too
17 highly, but I think you can discern a consumer concern, consumer focus in
18 some of it when you look at the, for example the key design principles
19 for the Governance Board's constitution, it talks about at least some
20 members of the board having expertise and experience in consumer
21 interests. I'm wondering whether that emerged from the - your inquiry,
22 or whether it was something that Government itself saw fit to put in its
23 guiding principles.

24 **MR CAYGILL:** No there was nothing specifically in the inquiry's recommendations
25 which related to how - which related to that. The inquiry simply said,
26 in fact the inquiry recommended simply that a majority of the governing
27 body of any new arrangement, should be independent of the industry. It
28 didn't go beyond that in terms of design detail. The design
29 specification you've referred to was injected by the Government in its
30 policy statement and is met in the rulebook, in the rules which relate to
31 the qualifications or expertise that the appointment process should look
32 for in compiling the list of potential members who are submitted to the -
33 who are submitted for a vote.

34 **MS BATES:** So the applicant's in agreement I take it.

35 **MR CAYGILL:** The applicant has no problem with that piece of design and believes
36 it's met in the rulebook. We haven't offered a - we're not proposing a
37 representational structure, we're proposing a structure on the other hand
38 that meets those - that kind of design requirement through the search
39 process.

40 **MS BATES:** Well as I said, we might come back to talking about the
41 representational structure and why you didn't go for that model later if
42 it becomes relevant. I'll leave it there. But there's just one other
43 question I wanted to ask you, and that was, you said that, and it's clear
44 that the Government prefers the self-regulation of the industry. I'd
45 just like you to venture an opinion on why that might be.

46 **MR CAYGILL:** I first heard that phrase in a slightly different context. I may
47 have this wrong, but I believe that it was Helmut Schmidt, the Chancellor
48 of Germany who used a phrase, he said that he or his Government, his
49 party, were in favour as much market as possible and as much regulation
50 as necessary. And what I think the Minister of Energy has done, has
51 taken that general aphorism or principle that had some currency amongst
52 centre left parties in Europe a decade or so ago, and applied it
53 specifically in this area, and I think it has a logical application in
54 this area, you've got public policy objectives on the one hand and some
55 capacity for the private markets and some need for regulation. All
56 that's happened is that that general philosophical approach has been
57 translated into a specific sector. This is a Government that favors
58 markets where markets can work as a first principle but says clearly they
59 won't always produce perfect outcomes, so let's --

60 **MS BATES:** It's left itself hasn't it, in the Act, a way in, to actually have a

1 fair degree of say over a self regulated industry, I mean the electricity
2 industry.

3 **MR CAYGILL:** Yes, that's clearly right. I read the Act, and indeed the
4 Parliamentary debates that surrounded it as, although the Crown EGB
5 appears first, it's sub-part 1, and then the electricity governance
6 organisations is sub-part 2, the fact that they're both there, the
7 provision is made for both of them, and yet there won't be much room for
8 an electricity governance organisational case if there is a Crown EGB.
9 It seems to me that Parliament must have meant that the EGO's should be
10 given a chance. And precisely as the Government had outlined in its
11 policy statement, and in the speeches in relation to the bill, if they
12 failed, the industry couldn't reach agreement, or they were not seen to
13 work satisfactorily, then an EGB, the Crown EGB would need to be
14 established and power was being taken now to achieve that so that there
15 wasn't a scramble at the last minute to try and get something up, should
16 it prove necessary. So, you've got a statute that provides for both, but
17 the sheer fact it provides for both when really only one can exist at any
18 one time, in my view implies, and I think the Parliamentary record
19 justifies this conclusion, that a majority of Parliament shared, or was
20 prepared at least to go along with, the Government's preference for
21 giving the industry the opportunity to regulate itself in the first
22 instance in a context, as you say, where the Government can intervene to
23 a considerable extent.

24 **MS BATES:** Mr Kos did you want to add something?

25 **MR KOS:** Sorry I was obviously bouncing around. That is usually a signal of
26 action. I do want to add because it's quite interesting to look at that
27 Parliamentary record that David Caygill's just referred to. This isn't a
28 transitory value voted with one party at one point in time, if you look
29 at the debates over the Electricity Industry Bill. What one saw the
30 consensus in favour of the self-regulating model spread far widely from
31 the Labour Party, but it spread to the Alliance which was part of the
32 Government, but then also to the Green Party. National and Act voted
33 against the bill on the basis they didn't want any farther of Government
34 regulation from which we can take it that was a vote for self-regulation
35 because that seemed to be the other alternative model and there was one
36 lone complaint for sole Government regulation which came from New Zealand
37 First. So, that showed at the Parliamentary level which is very
38 important, a very gored consensus in favour of this.

39 **CHAIR:** Could I just add two more questions and then perhaps time for tea. In
40 talking about the possible Crown EGB, and starting from the basis as
41 you've said that part of the counterfactual is that at least public
42 debates operational rules would be incorporated fairly quickly into a
43 Crown EGB, would you think there would be the same relationship between
44 the board of that entity and people making the rules at NZEM etc, that
45 would be under the industry EGB.

46 **MR CAYGILL:** I cannot conceive that there would be. Firstly it's plain from the
47 statute that there is a very different appointment process. These are
48 the Government's appointees, it doesn't - I don't see that as going to
49 quality. But I do see that going to accountability. These are not
50 people elected by any industry, these are people appointed by the
51 Minister. And secondly, it seems to me that the Crown EGB is likely to
52 be governed by rules of procedural fairness. If it's proposing new rules
53 it will clearly need to go through a process that notifies people of that
54 and gives those who believe they might be affected some opportunity to
55 comment and so forth. But that's a very different process from the kind
56 of process contemplated by these rules where rules get changed in a way
57 that involves working groups constituted at a level of expertise by those
58 who know about the particular issue and can comment on it, can seek to
59 reach a consensus, that is then tested against a set of high level
60 principles and then approved as such by an independent body, and then,

1 and only at that point subject, if need be, to a vote.

2 I see a Crown entity, engaging in what strikes me with respect as a
3 series of bilateral relationships, holding hearings probably, and then
4 retiring and making its decision. Almost as though it is operating in a
5 quasi judicial manner, the more it engages and involves itself in
6 procedural rules, the more that's the direction it will be forced. And
7 then that's offset by an intimate dialogue with the Minister. But
8 there's no - there's nothing in the Act which requires any intimacy of
9 dialogue with the industry. Procedural fairness yes, but there's no
10 working group layer.

11 **MS REBSTOCK:** Is that necessarily the case, is there any reason why a Crown EGB
12 wouldn't use working parties in precisely the same way? In fact,
13 wouldn't they probably be driven to that, given the specific - where the
14 expertise sits in the industry?

15 **MR CAYGILL:** I acknowledge that there is nothing in the Act which excludes such
16 arrangements, that's plain. All I can say is I don't have any degree of
17 confidence that that is likely to emerge. My opinion is that it is not
18 particularly likely. That is because this is a body which would
19 ultimately be accountable to the Minister, and the Minister alone.
20 There's no accountability to the industry as such, if --

21 **MS REBSTOCK:** Wouldn't the industry ultimately be accountable to the courts?
22 Wouldn't they be - the procedural fairness for natural justice, require
23 them to have engaged with the industry, heard the industry.

24 **MR CAYGILL:** Yes.

25 **MS REBSTOCK:** Received expert advice from the industry, considered their
26 proposals, and in that sense it wouldn't, having a Crown EGB would not in
27 any way which was accountable to a Minister, would not in any way change
28 the fact that, at the end of the day, the courts because of natural
29 justice would require that body to have been engaged with the industry
30 and heard their views.

31 **MR CAYGILL:** Yes, I accept all of that, and indeed - that was the point I was
32 trying to make. But I see that as a different process from the working
33 group process. This is a - the Crown EGB is a regulatory body. It will,
34 I believe look like and operate like the regulatory bodies both here and
35 in other countries. There is a - there will be, I would expect, some
36 formality to its processes, precisely so that it can demonstrate
37 subsequently a challenge that it was - its procedures were fair, and then
38 it makes decisions subject only to the Minister's ultimate capacity to
39 say no, that's not what I'm looking for here. This is a proposal - the
40 Crown EGB would invite lobbying of the Minister, if not of itself,
41 precisely because either it or the Minister, in this kind of a bit of a
42 go around between them, has the final say. It's the very fact that the
43 industry EGB does not have the final say that changes the nature of how
44 it will operate. It will be - it will certainly interface with the
45 Minister, and yet need to be more conscious of what is a reasonable
46 outcome. I believe than the Crown EGB will be. I think the Crown EGB is
47 more likely to feel able to act dramatically, but that doesn't
48 necessarily mean act in ways that are ultimately the most efficient. I
49 think the Crown EGB would be more likely to be able to operate in fits
50 and starts of major reforms, the industry EGB is more likely to operate
51 in a larger number of more discrete refinements. None of this can be
52 demonstrated, none of this is absolute, none of this is inherent. If you
53 ask my opinion as somebody interested in governance issues, that's all I
54 can say. That's how I would expect the two bodies to head, given their
55 different structures and rules.

56 **MS REBSTOCK:** It almost sounds like I think, I can't remember which party it was
57 so you'll have to excuse me for that, I think it might have been Mighty
58 River Power, maybe not Mighty River Power, I'll look at it. At some
59 point there's a description of a form of organisational inertia that
60 might happen which almost sounds like slow decision-making's evolving.

- 1 **MR CAYGILL:** I don't think the distinction is one of speed. Remember again, the
2 industry EGB is not on its own. It has to negotiate a set of performance
3 targets every year with a Minister who is specifying objectives. But
4 that's a very transparent process. There's nothing - if you think of the
5 equivalent, what does the Minister expect of the Crown EGB, that may be
6 nowhere near as transparent, what really matters in relation - in respect
7 of the relationship between the Minister and a Crown entity, may well as
8 with a number of the New Zealand Crown entities, be a matter of private
9 conversation that is nowhere documented or recorded.
- 10 **MS REBSTOCK:** That happens now, does it?
- 11 **MR CAYGILL:** Well, if I say that I chair the Board of the Accident Compensation
12 Corporation, and the most important conversations that impact on that
13 board --
- 14 **MS REBSTOCK:** I mean with the electricity industry.
- 15 **MR CAYGILL:** Yes, in some respects. Except that --
- 16 **MS REBSTOCK:** And we have a self regulating model now.
- 17 **MR CAYGILL:** Yes, only every two months we are obliged to document our process -
18 our progress rather, and the Minister has, wisely I think but happily
19 from our point of view, published those reports. So, the conversations
20 are private, but the product of them is not.
- 21 **MS REBSTOCK:** But that has nothing to do with whether it's a Crown board or an
22 industry board, because we have an industry board now. So, when you have
23 a Crown board you normally, in a transparent way, with some external
24 advice, negotiate a publicly available document on Government priorities.
25 But I'm just trying to understand when you say that the thing you're
26 concerned about happening under a Crown EGB is happening now, where there
27 is no Crown EGB, but three independent industry bodies, so I'm just
28 trying to understand what's going to change if you had a Crown EGB.
- 29 **MR CAYGILL:** I believe the level of documentation that we've provided in this
30 process every two months, greatly exceeds the kinds of documentation that
31 most Crown entities in New Zealand are obliged to produce once a year.
32 That there is a much greater richness of information in the processes
33 that are available, that are available now. In some ways what is
34 happening now is very ad hoc. I can't be certain that it's precisely how
35 things will develop in future under the Electricity Governance
36 Organisation section of the Electricity Act or under the Crown EGB. We
37 can only speculate about that.
- 38 **MS REBSTOCK:** I mean normally you don't necessarily equate ad hoc procedures
39 with transparency. I mean it's quite an interesting thesis in a way
40 because most principles of governance would suggest ad hoc procedures
41 don't lead to transparency.
- 42 **MR CAYGILL:** All I can say is the Government policy statement required us to
43 report every two months and we have, and the Minister's chosen to release
44 those reports, that's been a useful documentation about process.
- 45 **MS REBSTOCK:** Sure and the Government policy statement is going to equally apply
46 to a Crown EGB, isn't that right?
- 47 **MR CAYGILL:** A Government policy statement will, to the industry - to the
48 electricity governance organisations. I'm not so certain that the policy
49 statement mechanism is the operational process in relation to the Crown
50 EGB.
- 51 **MR KOS:** It is but then there are supplementary powers of direction. So,
52 there's a fundamental difference between three states: The first state
53 is the kind of prelude to one or other form of board that we're currently
54 going through at the moment with EGB undertaking some of those
55 responsibilities but still not the statutory stuck you are then you have
56 two alternatives. With the Crown EGB you have a quite different tension
57 between the Minister and the industry from the tension that you have with
58 an industry EGB and the Minister. In the case of the Crown EGB you have
59 a far more directorial power on the part of the Minister. Fundamental
60 difference in the tension.

1 **CHAIR:** A lot of it depends on how it evolves. My guess is, whatever
2 structure is finally agreed and emerges, the degree to which the outcomes
3 reflect over where the Government want to head will determine to some
4 degree the sort of daily interface with the Government. But there's
5 another point in it which was the basis of my original question, one or
6 two of the submissions, I'm not sure whose, make the point that because
7 of the intellectual property involvement, or what have you, by certain
8 parts of the industry, rule making per se needs to have a fair input and
9 acknowledgment of those investment in intellectual property interests.

10 It seems to me under a Crown EGB that tension will still be there,
11 but if I'm a generator or in particular under a Crown EGB, wouldn't it be
12 logical that you'd still want the NZEM rules for example or the rulebook
13 in totality to at least reflect some of that financial stake I've got in
14 the industry, regardless of the Government structure at the top. You
15 seem to be saying that even market rules would have to be negotiated,
16 discussed and directed from the board itself, rather than down in the
17 marketplace.

18 **MR CAYGILL:** I think it's - I think part of the problem with assessing the
19 counterfactual is, it's all very unclear. All we've got is a statute to
20 go by and the rest we're guessing to a considerable extent. I assume
21 that - the only way to run a wholesale market is to have somebody who's
22 operating it in real time, making the quality trade-offs against the
23 efficient disclosed price. There will need to be a system of market
24 administration which is set up sufficiently independently that it --

25 **CHAIR:** That it will get on it.

26 **MR CAYGILL:** Yes, that it operates in real time. Mr Chairman I don't know to
27 what extent issues of intellectual property would prove problematic.
28 Certainly the Electricity Governance Establishment Committee has not seen
29 intellectual property issues as being of any significance at all. We
30 could go into the specifics later.

31 **CHAIR:** Perhaps if people with investment in generation have got a similar need
32 to have a say according to some of the submissions we've had, as to the
33 rules that are developed and implemented, to trade their product in the
34 market, that's made in one or two of the submissions.

35 **MR CAYGILL:** Clearly they do have a need and I don't doubt that a Crown entity
36 will operate in a way that is procedurally fair. But it doesn't seem to
37 me that there is any guarantee that with the system, whatever it is,
38 rules, regulations, code, what have you, for which the Crown EGB is
39 ultimately accountable to the Minister, will contain the same degree of
40 devolution or of flexibility. If I can give an example. One could say
41 that quality issues at the moment are the subject of regulation. That's
42 literally true in a minor respect, there are some aspects of the
43 electricity - there are regulations made under the Electricity Act which
44 bear on quality issues.

45 More significantly, Transpower dictates, determines the frequency
46 and voltage standards that are part of what it terms common quality
47 obligations. That's a central determination as distinct from an industry
48 determined standard. It's much less flexible and arbitrary and we could
49 demonstrate if you - if it was useful, the costs on the economy as a
50 consequence of that different approach, precisely where the industry has
51 sought to move to a more contractual framework. It's not clear whether a
52 Crown EGB would - in a clash between the risks that are consequent on a
53 standard based approach, or the efficiency advantages that flow from a
54 standard based approach, which would prevail.

55 One of the submissions the applicant makes is that a Crown EGB is
56 probably, we believe, we would argue, more likely to be conservative
57 about that. Central institutions are more likely to be risk averse to be
58 concerned at the risks if the lights go out than concerned for the
59 efficiency advantages. I can't prove that, but that's our view. Well,
60 it is not hard to imagine how you resolve quality issues. You just

1 specify the standards. That's how voltage and frequency is set around
2 the rest of the world by regulators of one kind or another. Let's not
3 argue about this any longer. That's the frequency range, system
4 operator, go and deliver to it. A contractual base is harder, more
5 problematic, needs more talking.

6 I can't prove to you a Crown EGB will be - will tolerate that or
7 care about it, all we can say is as between those two alternative
8 approaches, we think there's some reason to speculate that a Crown EGB
9 will be more likely to be conservative. Can it be regulated? You bet it
10 can, it's regulated everywhere else. The fashion everywhere will be able
11 to be pointed to as precedent for a restoration of central regulation of
12 quality issues. They may not seem terribly central here, they're not the
13 most obvious issues raised by the rulebook, but they do happen to have
14 millions of dollars hanging off them just in that set of issues alone.

15 **CHAIR:** Just one final question. 223, you made the point I think, you
16 emphasised it that what is in the rulebook is likely to command more
17 support than any other set of arrangements etc. You made the point
18 earlier on that currently, NZEM, MARIA and MACQS, the degree to which
19 MACQS is operational or not, basically are supported by the industry
20 because the thing's working at the moment, those systems are working.

21 Now, if indeed the operational side of the rulebook, at least
22 initially, is not too different under the counterfactual or under the
23 proposal, then a number of submissions have come in either opposing or
24 asking some fairly big questions about the proposal in front of us. Do
25 you see that slightly inconsistent with the fact that up till now anyway,
26 under several Government structures the operational side of the industry
27 has carried on. As you said earlier, lights are still on etc. Some of
28 the questions now being raised, do they come as something of a surprise
29 in that context.

30 **MR CAYGILL:** I think I'd probably need to say that, I don't find it surprising.
31 If - there are plenty of people who would like to change NZEM from what
32 it is now, would like to make changes to MARIA, indeed if I take MARIA
33 for a moment, MARIA's currently engaged in a major revamp of the registry
34 rules. It's another subject that they would like to tip into our
35 rulebook but you know they weren't there at the end of last year and we
36 said well we've got to get on and make this application. So, people are
37 keen to make improvements and there's no shortage of ideas about further
38 ways in which the rulebook might evolve of. So, some degree of dis-
39 sympathy for the existing codes is not a surprise, not novel. However,
40 where I take the point in your question, what you have at the moment are
41 three rulebooks which, in combination are producing a functioning
42 coordinated system, bit awkward to co-ordinate three different bodies,
43 not hard to see how some rationalisation might improve things and so on
44 and so on. But in real time, actually the system is operating, and
45 vastly more efficiently than it did before we had a wholesale market.
46 When all you had was a single average price across the whole of
47 New Zealand, no locational signals and so on. So, somewhere between the
48 fact that what we have at the moment is hardly all bad, though no doubt
49 can be improved, there's some lesson I believe about the value, the good
50 that can come from industry arrangements. Perhaps I could put the point
51 more simply, nobody I believe is turning up in front of the Commission
52 and saying this is all nonsense, we ought to go back to where we were
53 before the market. Everybody who thinks that they would like different
54 improvements in the market, many of them quite inconsistent with each
55 other, is nevertheless arguing from a premise which implicitly suggests
56 our arrangements are working relatively tolerably, which is the
57 foundation for our argument that an industry arrangement ought to be
58 allowed to evolve further from here.

59 **CHAIR:** Thank you very much.

60 **MS BATES:** You were saying - felt that the Crown EGB would be less transparent

- 1 than an industry EGB.
- 2 **MR CAYGILL:** In some respects I believe there is a risk of that yes.
- 3 **MS BATES:** You probably know the provisions of the Electricity Amendment Act
4 2001 much better than I do. But there's 172.Z.K which talks about
5 setting objectives of and outcomes and it talks about the Electricity
6 Governance Organisation having to report and the Electricity Governance
7 Organisation in this subpart includes a Crown EGB. Is that not right?
- 8 **MR KOS:** Yes, that's right.
- 9 **MS BATES:** So there is obligations under the Act, there's just one more
10 provision and possibly more, but under 172.Z.M there's a requirement that
11 there's to be an annual performance report to the Minister. So, I just
12 put it to you, those couple of provisions would seem to me to be aimed at
13 producing some transparency and I just wanted to have your comments on
14 those.
- 15 **MR KOS:** Those are common. Those are common to both models. But the two
16 differences are these. First of all there is the difference in the way
17 in which the two bodies would actually operate, which is the point that
18 David Caygill is talking about. And the other point we draw the
19 Commission's attention to is section 172.Z.A which is unique to the Crown
20 EGB and is the minister's power to direct it.
- 21 **MS BATES:** Yes, that's the - I think the performance standards are also only to
22 the industry EGB, aren't they?
- 23 **MR KOS:** Depends on whether the industry EGB is an EGO.
- 24 **MS BATES:** Agreement of annual performance standards I understand Mr Caygill to
25 be saying those were only to be applying to industry EGB's. That's
26 172.Z.L.
- 27 **MR KOS:** Sorry you're quite right, says that the agreement of performance
28 standards is EGO other than an EGB.
- 29 **MS BATES:** So that's something unique to the industry?
- 30 **MR KOS:** Yes.
- 31 **MS BATES:** Yes, that was the point I wanted to make. Just the differences again
32 that you said were --
- 33 **MR KOS:** Well first of all the way in which in practice they would operate.
- 34 **MS BATES:** Yes got that one.
- 35 **MR KOS:** Secondly the agreement of Parliament standards with the evaluation
36 that follows, which you quite rightly identified, and thirdly the
37 ministerial power to direct. May I make just one very short comment
38 following from David Caygill's last point in relation to some of the
39 missions the Commission is considering there is an important distinction
40 isn't there between what amounts to suggestions for design improvement
41 from submitters and submissions which in fact go to the question of the
42 net public benefit, net public detriment from the model that's been
43 presented which, in my submission, is much more the business we must
44 consider here, the industry itself will consider design improvements to
45 the model in the rulebook evolution.
- 46 **CHAIR:** Certainly note that point. Well, I think we should break now perhaps
47 for quarter of an hour. But I think even though we're running behind
48 time I think they're very critical issues that Mr Caygill's been good
49 enough to take us through and I'm just signaling that I wouldn't want you
50 to cut down the rest of your submission. We can go over tomorrow or
51 whatever, so I think it's very important we give full opportunity for
52 them both as we work through it. Perhaps we'll come back at 11.15.
53 Thank you very much.
- 54 **(Adjournment from 11.00 to 11.20 am)**
- 55 **CHAIR:** We'll start again. Just before asking Mr Kos to speak, one more
56 question from the Commission to Mr Caygill.
- 57 **MR CURTIN:** If I could just ask you, you mentioned earlier about the
58 arrangement, the purpose of the arrangements being to find a useful
59 tension between the common interest and industry interest. I suppose a
60 number of the submissions have made the point, if I could pick up your

1 company director's analogy, that the powers of the industry EGB are
2 actually a good deal less than the powers of the Board of Directors of a
3 company would be, and in fact a lot of the submitters have taken the line
4 that the powers of the independent board are less than are required to
5 see that the common interest gets a good enough look in at the end of the
6 day, and I wonder if you'd care to comment on that line of argument.

7 **MR CAYGILL:** I'd be - thank you, I'd be pleased to. Yes a number of submitters
8 have made that argument. It's not an argument that I accept. I think
9 that much that's been - it's in a new argument, it's an issue that has
10 been debated - was - has been debated a lot within the Establishment
11 Committee and the working groups. I think that view reads down the
12 powers of the board and underestimates the way in which in practice it's
13 likely to operate. I think the board has the power to set the agenda.
14 The board has the power to initiate rule changes, to prioritise work, to
15 ensure that the board will set the composition and terms of reference of
16 working groups. So, in that sense it will supervise the development, may
17 not be able to unilaterally be able to approve the ultimate rules, but it
18 can ensure that work is heading in a particular direction. It has all
19 those powers and will need them because the board is the body which has
20 signed off each year with the Minister on the performance targets, and
21 it's the board in the first instance as the representative - as the
22 governing body whose performance is going to be judged by the controller,
23 and by the Parliamentary Commissioner for the Environment and by the
24 Minister.

25 Also, I think the board will in a slightly less formal way have a
26 great deal of influence and I would anticipate would exert that
27 influence. A board can't, any more than a corporate Board of Directors,
28 approve changes to the constitution, the rules, but does that mean it's
29 indifferent to the outcome? I hardly think so. It's going to, if it
30 believes that rule changes are necessary, it's going to seek to ensure a
31 particular outcome. If having submitted a rule change to a vote, were
32 that to be defeated, we'll come to how likely that is at the relevant
33 point of our discussion, any self-respecting board is likely to ask
34 whether what's happened doesn't amount to a want of confidence on the
35 part of members in the board. There's a tension of that kind in any
36 governance arrangements, even if the board can't change the rules. The
37 board has to say well, are we being sent a message by the members and
38 that says something about the board's power to avoid that outcome, and to
39 make it clear to members that are there consequences of heading in a
40 certain direction.

41 Finally can I say, I think this is important, I believe that what
42 we are proposing in this respect meets the Government policy statement
43 requirements. It may not - it isn't - it doesn't enjoy the unanimous
44 support of the industry, it is an issue that it had the support of a
45 significant majority of the governance working group and the
46 Establishment Committee, having debated it more than once, we kept coming
47 back to the same conclusions about the - where the balance of
48 responsibilities and powers should lie and believe that what we're
49 proposing meets the fundamental design criteria in the Government policy
50 statement, whilst coincidentally reflecting the existing arrangements as
51 well. None of the existing arrangements have governing bodies that allow
52 - who have ultimate change of the rules. So, in that sense we're
53 continuing something with which the industry has a degree of familiarity
54 and comfort.

55 **CHAIR:** Thanks Mr Caygill. Mr Kos please.

56 **MR KOS:** Thank you Mr Chairman, members of the Commission, we've, as I
57 mentioned before, identified these 19 issues. In one sense it's
58 appealing to continue the discussion at a very high level. The other
59 point here we're going to drill down to some of these issues and
60 hopefully we can pick up the wider debate as it goes through. I

1 understand the Commission has some additional time so that we don't have
2 to constrain ourselves completely.

3 **CHAIR:** As I said at the outset we'll do our very best that everybody who
4 wants to be heard is heard, so proceed on that basis.

5 **MR KOS:** I'm grateful, thank you. We'll go as economically as we can. The
6 first of the issues we pick up at page 8 of the notes is in relation to
7 the counterfactual. There seems to be a reasonable accord between the
8 applicant and the draft determination and most of the submitters, that
9 the counterfactual is a Crown EGB and that it would begin at least with
10 operational rules very similar or the same, as those proposed in the
11 proposed arrangement.

12 It's probably worth noting in terms of the debate that had gone on
13 before tea, that that counterfactual of course does not include a direct
14 consumer representation, nor does it include the concept of the Crown EGB
15 as a body with final determination powers. So, there is a great
16 similarity we believe between the operational structure of the two
17 proposals. We've teased out in the discussion before tea the differences
18 in which they would work in practice, which is a different matter from
19 the rules and has more to do with the different statutory nature of the
20 establishment of those two bodies.

21 But, while there is this accord, relative accord, there are some
22 opposing submissions and as we've noted at the bottom of page 8, there
23 are two principal alternatively counterfactuals advanced by opponents,
24 the first of which principally advanced by the major users group and the
25 CC 93 group, is renegotiation of the current rulebook on the basis that
26 it's highly unlikely that Government would regulate to form a Crown EGB
27 this election year, and the other alternative noted at the top of page 9,
28 is the continuation of the existing arrangements, the three codes,
29 possibly under a crown EGB and that's put forward by Transpower and by
30 the Sustainable Energy Forum.

31 Well, we don't agree with either of those alternatives as we noted
32 at 1.7 and there are a couple of reasons principally for which we
33 particularly reject the first proposal, first alternative proposal. As
34 Mr Caygill said, the proposal arrangement opinion represents the
35 strongest compromise that can be achieved and there's really no reason to
36 believe that a different bargain consistent with the Government policy
37 statements achievable. We've referred at B.2 there to the intense
38 process of consultation which you've heard a lot about this morning as
39 well. We conclude in that section that substantial ground-up revision in
40 the manner suggested by consumer interests would merely invite
41 reappraisal and unravelling of the compromise achieved.

42 But probably more importantly is the second reason, apart from the
43 industry there is the overall programme of Government in relation to the
44 GPS and there's no reason, in our view, to believe that Government would
45 allow the industry the extensive extra time that the alternative
46 counterfactual assumes. The GPS itself requires the industry to move
47 quickly to put in place the new governance structure. The GPS also
48 provides, that in the event of insufficient progress, the Government will
49 regulate under the Parliament sub-part 1 of the Act which is provided for
50 already. The process has obviously been underway for 18 months. The
51 Minister's been reported as saying that progress has been slower than
52 he'd like and there's still a process to go through even if and after
53 authorisation.

54 So, in our view there's simply no basis to say that there is a
55 realistic prospect of that counterfactual arising. The other, second
56 alternative which we deal with at E, at the bottom of page 9,
57 continuation of the three existing rule books in our submission, is an
58 even more unrealistic, it would involve Government condoning the
59 abandonment of important outcomes and objectives of the GPS, which
60 include drawing transmission into the self regulated arrangement, which

1 has been done in terms of this proposed arrangement, and also the loss of
2 enhanced consumer participation in that process, and the same reasoning
3 we submit excludes the SEF's hybrid market proposal which was circulated
4 I think yesterday. That's really in very short compass what our
5 submission today is on that issue of the counterfactual.

6 **MS REBSTOCK:** I'd like to ask you a couple of questions. With respect to the
7 first point about the proposed arrangement representing the strongest
8 compromise that can be achieved, I have no reason to doubt that may in
9 fact be the case, that it represents the strongest consensus, but it's
10 not clear to me that, in fact it seems very obvious that the Crown EGB
11 does not have to achieve the strongest consensus possible. That has
12 benefits and it has draw backs, this need to achieve the greatest
13 consensus. It does not - it would not be restricted to defining a
14 consensus it seems to me that is built around industry looking after its
15 commercial interests and weighing that up against what would be most
16 consistent with the GPS.

17 In fact it could pursue an approach that it considered most
18 consistent with the GPS and would not have to be mindful of the degree to
19 which that reflects the particular self interests, or the commercial
20 interests of the different industry parties. So, I don't really
21 understand the point. I don't understand why that suggests that the
22 counterfactual that we have is the only counterfactual we could have.
23 So, I just, I want to understand is in that context of the
24 counterfactual.

25 **MR KOS:** I think we may be at very slight cross purposes. I'll make the point
26 perhaps more clearly than I did the first time around. The alternative
27 we're talking about here is not the Crown EGB. We agree that's the
28 counterfactual. Others have suggested that in fact the real alternative
29 - the real counterfactual is for the Commission to decline the
30 authorisation and for the industry to go back and do this again properly.

31 **MR CAYGILL:** We're not making the point that the Crown EGB and our proposed
32 arrangements are identical in detail or impact or indeed we argue that
33 there's a significant difference in terms of benefits and detriments,
34 we're simply saying that a modified industry rulebook, modified in a way
35 that might meet some of the interests of, or views of objectors, is not
36 an available counterfactual because it lacks the agreed base on which any
37 industry rulebook is dependent.

38 **MS REBSTOCK:** Can I just take it a bit further. The consensus that was reached
39 and the arrangements that were presented to the Commission, was what was
40 possible under the previous condition, which was you were working with an
41 industry that was responding to trying to find a balance between its own
42 commercial interests and the GPS. We've already seen actually in
43 response to the draft determination, which I emphasise was just a
44 preliminary view of the Commission, that actually the applicant has
45 demonstrated that if signals and conditions change you can come up with a
46 different consensus. In fact you have put to us possible conditions
47 which to some extent address some of the concerns raised by a number of
48 parties, and to some extent they don't. I'm sure we'll hear from them.

49 So, I'm not quite sure that even with that explanation, the first
50 point holds, you've already demonstrated that a different consensus is
51 possible by having voted on certain conditions, if the emphasis in the
52 GPS is seen in a certain way in terms of its competitive effects.

53 **MR CAYGILL:** The conditions are not preferred.

54 **MS REBSTOCK:** No, I know they're not preferred.

55 **MR CAYGILL:** So they don't represent a greater compromise. They represent in
56 fact - they don't enlarge the area of agreement, they actually on balance
57 subtract from it but the less are offered as --

58 **MS REBSTOCK:** That maybe the view of the applicant that they're not the area of
59 strongest consensus. They wouldn't be a preferred outcome. But there
60 are other parties who clearly don't agree with that view. So, it does

1 seem to me that it must at least be in practice correct to say that what
2 you were able to achieve in terms of this consensus related to the
3 perceived balance of the industry parties between their own commercial
4 interests and how much they needed to do to meet the GPS and to get
5 authorisation, when you look at competitive effects. So, if something in
6 there changes, a signal changes there, it is possible that if you went
7 back and had another go that you might come up with something different
8 and you might achieve more consensus.

9 **MR KOS:** I think we need to be clear that the proposed arrangement is no more
10 fixed and immobile than it is possible to fix and make immobile electrons
11 running down the national grid. This is a dynamic proposal.

12 **MS REBSTOCK:** Sure, that's exactly my point.

13 **MR KOS:** But the point we're making is that the proposal that comes to the
14 Commission now is the product of such intense process that the
15 probability that we could come back from an authorisation and re-commit
16 the whole process again through that and come back again, probably will
17 self-defeat at the industry stage and if it doesn't self-defeat at the
18 industry stage then it will self-defeat at the industry stage, which is
19 our second point.

20 **MR CAYGILL:** I accept the point that's being made. Perhaps with this proviso,
21 that our arrangements were also constrained by time. The Government has
22 said on a number of occasions over the last year this process is dragging
23 on, yes you need to consult, you know, but there is a limit, you know,
24 yes we have a preference for self Government, but not forever. So, a
25 different consensus might be achievable in the space of another year, I
26 have no reason to think that that year is available to the industry.

27 **MS REBSTOCK:** Part of the reason I'm pursuing this question on this is I think
28 the issue of concern sort of immediately focuses on this possibility,
29 because we will have the discussion about whether it is appropriate for
30 us to impose conditions of the nature we've talked about, whether it's
31 desirable and all sorts of other things, but there is always the
32 possibility in that debate that the Commission could come to the view
33 that those conditions, if they were desirable, fundamentally change the
34 proposal that - for the purposes of natural justice, it should be treated
35 as a new application. Are we ruling now, are you in fact telling us with
36 this comment here that there would be no possibility of another round
37 with those conditions, if that - if - and I'm making huge assumptions
38 here because we still have to work through it, but if we went through
39 this whole process and yes we thought the conditions might address some
40 of the concerns in the draft determination and they were necessary, but
41 they were so fundamental that in effect they represented a new
42 application, that in your view there would be no scope for another round.

43 **MR KOS:** The question of the counterfactual is what is the most pragmatically
44 likely alternative.

45 **MS REBSTOCK:** I understand that. The circumstances we're in demonstrates that
46 there is at least the possibility of that being a real likelihood.

47 **MR KOS:** We've got to again distinguish between the dynamic nature of the
48 application which incorporates its own prospect - it's about a rulebook
49 which incorporates change itself, but what we are submitting to the
50 submission is that the most likely alternative is that if this process
51 has to go through another round of industry, that the Minister will blow
52 the whistle on it and that that - the Crown EGB, which is the ministerial
53 creation, is the most likely pragmatic alternative.

54 **MS REBSTOCK:** I understand what you're saying. We'll come back to this issue
55 around conditions. But I hear what you're saying is that there's no
56 scope for another round. You're actually saying the Minister won't allow
57 it.

58 **MR CAYGILL:** I can't comment - I can't speak for the Minister in that way. I
59 can say, if we leave aside the question of what is the appropriate
60 counterfactual against which to assess the application, that was the

1 primary point we were seeking to address at this moment and just focus on
2 well, what might happen if, I can make a factual statement to you that
3 the Minister has expressed to the Establishment Committee on a number of
4 occasions, his concern at the length of time it has taken the industry to
5 get to the point of submitting our application, and secondly I would have
6 to speculate because we have not discussed the matter directly, that the
7 industry like everyone else would need simply to consider and reflect on
8 any determination of the Commission. I don't have any information beyond
9 what I've already shared that would allow me to predict the Government's
10 reaction. I think I'm uncomfortable trying to do that.

11 **MS REBSTOCK:** I'm not - certainly wasn't asking you to do that, but it does seem
12 to me that this argument here may have a little more force because of
13 developments since we put out the draft determination, in terms of the
14 responses and how that is to play out we don't know. But at least there
15 is now on the table new information that we didn't have when we wrote the
16 draft determination. So, it may have some bearing on the counterfactual,
17 and so I wanted to give you that opportunity to address that.

18
19 With respect to the second alternative counterfactual which is, which I
20 think Mr Caygill mentioned was a real possibility under the legislation
21 that the three bodies would basically continue in their current form and
22 adjustment could take whatever form it took, if I understood you
23 correctly you said the weakness with what and why it wouldn't be
24 acceptable was because you would forego some of the other parts of what
25 the governors put in the GPS. In particular, some of the issues around
26 transmission. But that seems to me an issue of timing because you start
27 with that how it progresses, you know there's no reason why it couldn't
28 deal with those issues, it may just not choose to deal with them in the
29 same time. It would still be obligated to meet the requirements of the
30 GPS and if the GPS required it to address transmission, it would have to
31 do so in due course. Is that not the way it would work?

32 **MR CAYGILL:** You may have misunderstood something I may have said earlier. It's
33 not my view that continuing the existing arrangements is an available
34 counterfactual.

35 **MS REBSTOCK:** Underneath the Crown EGB it would be, would it not be as part of -
36 -

37 **MR CAYGILL:** If there is a Crown EGB as well as the existing arrangements, then
38 there's a Crown EGB, that's a - I would regard that simply as a way of
39 thinking about how the Crown EGB might operate, as distinct from a
40 counterfactual which posits the existing arrangements but no Crown EGB.

41 **MS REBSTOCK:** So when you were talking before about the three existing
42 arrangements continuing, it's feasible under the legislation for it to
43 continue, that was in the context of a Crown EGB was it?

44 **MR CAYGILL:** No. I think what I was talking about at that point, I apologise
45 for giving rise to the misunderstanding. I think I was simply trying to
46 discuss the meaning of those provisions in the Act and observing that as
47 they stood they were capable of being applied to the existing
48 organisations and then asking the theoretical question, well why has that
49 not happened, answer, primarily I assume because the Government has seen
50 no value in doing that, but has rather observed that these three
51 organisations are committed to achieving the Government policy statement,
52 which requires rationalised governance, rules which address transmission,
53 and so on. I don't know what the Government might do if it was persuaded
54 it was necessary to establish a Crown EGB, but I frankly cannot envisage
55 that it would establish a Crown EGB that did not immediately address
56 transmission issues. The Minister has always emphasised his desire to
57 see that aspect of function addressed and yet it is not addressed in the
58 three arrangements at the moment, which is why we have given priority to
59 seeking to address that area in the new rulebook.

60 **MR PALMER:** There'd always be some difficulties applying the Crown EGB model on

1 top of the three existing arrangements which have three separate
2 governance structures whereas the Crown EGB model inherently assumes a
3 single unified governance structure.

4 **MS REBSTOCK:** But you could presumably run three bodies, managed as they're
5 managed, but governed through one structure

6 **MR PALMER:** If you go through that transition that is the process of the last 18
7 months, the last 18 months is incorporated in transport, so again as
8 David says it's hard to imagine the Government would prefer to do that
9 rather than adopt where the industry has reached now.

10 **MR CAYGILL:** I think the truth is that even as early as the inquiry the industry
11 had reached a stage where it saw three separate governance structures as
12 disadvantageous, suboptimal. With three structures there were at least
13 two bilateral liaison groups, if not three linking right around, it had -
14 we've long since got to the stage where the most obvious thing to do,
15 whatever else, is to rationalise the governance and I know of no objector
16 who finds fault with that principles, it's obviously a question of how
17 the body is constituted rather than whether there should be a single
18 governance entity.

19 **CHAIR:** I think you mentioned in that in your opening statement. Just
20 following on from that, one or two of the submitters in relation to the
21 counterfactual have said that given time that might be involved in
22 setting up a Crown EGB, there still might well be the alternative coming
23 back to the EGBL to see if they could renegotiate some of the issues, in
24 12 months or 18 months it's talked about by some submitters in relation
25 to putting up a Crown EGB. Secondly, as you explained, given the amount
26 of work done by this group over the last 18 months or two years, isn't it
27 likely that there'd be some merit in trying to build on that as an
28 alternative than going to a Crown EGB straight away, it's just a
29 question. I'm quoting other submitters rather than the Commission's view
30 on that.

31 **MR CAYGILL:** What strikes me is that the issues raised in the opposing
32 submissions are not new. Doesn't mean they're wrong but they are not
33 new. Of course taking more time to discuss them again, second or third
34 or seventh or eighth time, might conceivably lead to a different outcome.
35 If we were to fail in this application, we failed to persuade the
36 Commission that as we have sought authorisation that's not available,
37 provided however for whatever reason there's a period of time available
38 to do some more work, and the Minister were to say to me David, do you
39 believe that talking further will lead to a different outcome, I would
40 have to say this morning I have no particular reason to think that the
41 answer to that is yes. Now, if however some lines are drawn, if this,
42 and this, and this is fine, however in this area what is needed is X.
43 That's a different case.

44 **MS REBSTOCK:** That was what I was trying to ask you.

45 **MR CAYGILL:** With respect that I think is in one sense what has happened with
46 the draft determination. The draft determination identified some issues
47 the Commission wanted particular focus on, we have responded by
48 discussing ways in which, if need be, notwithstanding the view we wish to
49 assert to you, that it's not necessary. But in the absence of datum
50 points against which changes can be assessed, all we have is the GPS, and
51 as against the GPS I can say only that what we have in front of you
52 represents the broadest compromise that we have been able to achieve in
53 the time available that is consistent with the GPS.

54 **MS REBSTOCK:** You do, I mean it's obvious that we would - this is just leaving
55 aside everything else and I'm not saying this is what we're going to do,
56 but should we decline the application you would anticipate possibly that
57 we might tell you why we did so and so I think we shouldn't be having
58 this, when we think about the counterfactual, we have to think about it
59 in that context. We shouldn't be thinking about it, all the information
60 on the table for you to work with is like it was the last round, which is

1 having just the GPS and the stated interests of the various industry
2 parties. At that point you would have most likely some clear guidance
3 from the Commission on what was the difficulties. So, in that context,
4 what I hear you saying to us is that you actually could not rule out this
5 counterfactual, that you might, if it was quite specific indications of
6 where the difficulties were and possibly there were solutions, for
7 instance as we see in the conditions that you've already suggested to us,
8 you couldn't rule out this counterfactual as being reasonably likely.

9 **MR CAYGILL:** No, I'm, with respect I'm not comfortable with a phrase like
10 reasonably likely. That isn't consistent with the Minister's clear
11 preference that this get itself off the ground already. I have no reason
12 to think that the Minister would indulge the industry.

13 **MS REBSTOCK:** I'm not asking what the Minister might do, I'm asking as chair of
14 this, would you think it was worthwhile to try again in those
15 circumstances.

16 **MR CAYGILL:** What I personally might urge the Minister to allow is one thing.
17 What goes to the availability of that as a counterfactual is the outcome
18 of that conversation and I have, it would be quite improper of me to
19 imply, or leave the Commission with any other impression other than the
20 Minister has said get on with this.

21 **MS REBSTOCK:** Can I just ask another question, I understand you can't speak on
22 behalf of the Minister, I wouldn't want you to think I'm asking you to do
23 that.

24 **MR KOS:** Are we moving topics?

25 **MS REBSTOCK:** No. If we were in the counterfactual sort of mode that has been
26 put forward as an alternative that you might go away and try again, it
27 seems to me that one of the issues for the Minister or for the EGB may be
28 the timeframe it would take for you to come back. Now, we saw you
29 consider conditions in the space of, what, a few weeks, six weeks or
30 seven weeks.

31 **MR CAYGILL:** In the period available between your draft determination and these
32 hearings, yes.

33 **MS REBSTOCK:** Right. So, when we compare that or setting up a Crown EGB and
34 taking into account the Minister's preference for an industry EGB and the
35 fact that you might very well come up with amendments to your application
36 to meet concerns, this is all just talking about what a counterfactual
37 would be if this doesn't happen. Not presuming that it won't. That
38 seems to have a lot of nice features compared to going straight to a
39 Crown EGB which the Government's, we all accept the Government sees as
40 second best, especially if it's a fairly short timeframe to turn around
41 an amended application.

42 **MR KOS:** What's troubling me very much about this discussion, though is that
43 the question in relation of the counterfactual is not what is possible,
44 the question is not what would you do if we declined you, the question is
45 what is the most likely alternative.

46 **MS REBSTOCK:** Yes, that's why I'm asking, given the Government's stated
47 preference for an industry EGB, given that you've demonstrated how
48 quickly you can come up with conditions that amend and meet competition
49 concerns, is it not likely that you would do that if this application
50 didn't succeed.

51 **MR KOS:** And if we did that, there's an enormous difference between coming to
52 the Commission with what we would submit are two quite small changes, no
53 doubt other submitters will enlarge them and say these are the biggest
54 things ever to appear before the Commission and justify an entire new
55 application and weeks of time to consider them. In truth they're small.
56 Two small modifying conditions as a response.

57 Along with what will no doubt be other changes, as I've said to
58 you, it's a dynamic application, it's a rulebook which will change,
59 changes have already been scheduled. These are all likely, but are we
60 going to come back here again in another six or eight months time and

1 have a very clean debate in which there will be no opposing submissions
2 because a new kind of consensus might just have been found which will
3 dissatisfy other interest groups and so we'll have yet another debate.
4 The main answer to that is, it is possible we could come back, is it
5 likely.

6 **MS REBSTOCK:** I don't think I'm suggesting to you the counterfactual is one
7 where there's complete consensus, it doesn't need to be that.

8 **MR KOS:** But is it likely we would, the Minister looking at this, again I can't
9 say what he would think, but he might think it sounds like a repetition
10 of a process that would fail once. The GPS is time bound and so we think
11 that the most likely alternative, and that's what the counterfactual is,
12 the most likely alternative is, is exactly the one in the draft
13 determination had been noted.

14 **MR HANSEN:** Can I perhaps draw the Commission's attention to the Murray Hansen
15 paper of December last year, paragraphs 32 to 44 which went through
16 pretty much this scenario, particularly if you then look at, I think a
17 relevant consideration here is whether in the second stage where the
18 application had been declined, would the industry see the conditions as a
19 positive net benefit or negative, relative to the current application.
20 Because at the time of the second application it would almost definitely
21 be the case the counterfactual is the Crown EGB, and if the industry saw
22 the conditions as negative, which has been indicated to you as the view
23 taken thus far, then the industry presumably would prefer to put up the
24 current application a second time, because at that second time the
25 counterfactual at that time will be the Crown EGB, because if we get
26 rejected twice, then presumably the Minister, certainly increases the
27 probability substantially that the Minister would regulate.

28 **MS REBSTOCK:** I want to make sure I understand this. You're actually saying
29 that despite having presented these conditions to us the industry would
30 prefer a Crown EGB to the application with the conditions?

31 **MR CAYGILL:** No the industry prefers the original application.

32 **MR HANSEN:** If you take it sequentially, and you go to the next step and suppose
33 that the application had been declined, the industry is then faced with
34 deciding to either not put up a submission at all, to maybe resubmit a
35 re-advised proposal which would presumably include the conditions, and
36 maybe other things or resubmit the previous proposal. At that point the
37 Commission needs to then say well what is the counterfactual at this
38 time, we're two, three months down the road, perhaps longer, the Minister
39 presumably is getting even more concerned about where this is leading and
40 I would submit that you would have to conclude that were that second
41 application to be declined, that the Crown EGB then would be the most
42 likely counterfactual. If you work back from there, if the industry's
43 looking at the conditions and saying well, we think this actually
44 detracts from where we got to in the first step, if we put up this new
45 proposal - if we put up the old proposal, the Commission will compare it
46 with the new counterfactual which is now the Crown EGB and on that basis,
47 assuming that that would then be passed as authorised on the basis that
48 the current application otherwise exceeds, has a net benefit relative to
49 the Crown EGB as the alternative. Does that make sense?

50 **MS REBSTOCK:** I'm sorry. I don't understand how you get to the last step. I'd
51 appreciate it if you'd go through it one more time.

52 **MR HANSEN:** If the Commission, it would depend to some degree on whether the
53 Commission indicated - the Commission will indicate net benefits relative
54 to the counterfactual it chooses. I guess if it chooses as the
55 counterfactual the current application plus some conditions, then we may
56 have somewhat less information as to whether you would have passed it
57 relative to the Crown EGB. But I suspect we could probably infer that
58 from the detail of the comments, or at least the industry would make a
59 judgment on that basis.

60 **MS REBSTOCK:** You're saying that your inference now would be that you'd be

1 better off just to accept a Crown EGB at that point.

2 **MR HANSEN:** No, what the industry would be doing would be making a judgment as
3 to, and trying to predict whether the Commission in that second
4 application would actually approve the existing, what is essentially the
5 current application, but it's going in a second time, or would it reject
6 it. If it believed that the Commission actually would approve it,
7 because the counterfactual at that time is the Crown EGB and not this
8 other one we're talking about, if it makes that prediction, holds it with
9 sufficient confidence, then instruct incentives would really just to
10 resubmit the current application.

11 **MS REBSTOCK:** Why is that, I don't understand that?

12 **MR CAYGILL:** Because so long as the applicant believes that if the only choices
13 on the table are the application and a Crown EGB, and the Commission will
14 find a net benefit as against that counterfactual, if that's our view in
15 X months time, then the clear incentive is for the applicant simply to
16 resubmit.

17 **MS REBSTOCK:** I understand if that's your view but why would that be your view,
18 that's the bit I don't understand. I hear you seeming to suggest that it
19 would be your view. I don't understand why that would be.

20 **MR CAYGILL:** It is our view now that the application is - has a net benefit as
21 against a Crown EGB.

22 **MS REBSTOCK:** Sure I do understand that. I do understand that. But you still
23 saw it in your interests to put forward conditions in case we didn't find
24 that.

25 **MR PALMER:** By waiting two, three, six months the counterfactual changes, it
26 goes - it becomes definite that it's a Crown EGB is the counterfactual.
27 So, the applicant could wait six months, come back and say well, although
28 at this hearing you thought the counterfactual was a revised rulebook, in
29 fact now it's clearly a Crown EGB, so here's our application again, we're
30 confident there's a net benefit. It's perhaps with that kind of risk of
31 game playing that the Commission said --

32 **MS REBSTOCK:** I see what you're saying, you're basically saying that you would
33 do that on the basis that you would convince us at that stage that you
34 were right in your first application this time, despite whatever's
35 happened at this hearing and the draft determination and the final
36 determination.

37 **MR CAYGILL:** If we believed we could convince you of the net benefit then that
38 is what --

39 **MS REBSTOCK:** I understand that.

40 **MR CAYGILL:** Can I just make a point that, which struck me really as important,
41 there's I think a huge difference between conditions which are offered up
42 reluctantly in the sense that they are not preferred in response to
43 explicit questions asked by the Commission in its draft determination, on
44 the basis we believe that the Commission has the power to attach
45 conditions to its authorisation, in other words by providing conditions
46 we are not in any way obliged to go right back to the start again and
47 make changes to an application which must necessarily involve a fresh
48 application, that a fresh application on a modified basis, reflecting as
49 it may be views reached by the Commission, is a wholly different thing in
50 time terms. Yes we've been able expeditiously to consult about, as it's
51 turned out, two specific narrow issues, in a frame of time created by
52 the Commission's timetable. I think the Minister would say in the
53 hypothetical scenario you've raised, you have failed. You made an
54 application at the end of last year, seven months later you have not
55 persuaded the Commission, the Commission's indicated perhaps it might
56 entertain a modified application but you will need to consult about that,
57 resubmit, go right through the processes again, that is a process which
58 clearly takes X months, nothing I can read in the GPS and nothing that I
59 have been party to in conversation leaves me sanguine that the Minister
60 would say by all means try again.

- 1 **MS REBSTOCK:** Thank you I'm sorry it took me so long to understand the point. I
2 did get it eventually.
- 3 **MR PALMER:** The Commission did consider this point in the NZEM submission and
4 noted there the authorisation process is intended the Commission to fine
5 tune particular proposals by, for instance, rejecting all applications
6 until one is received, which matches in detail the counterfactual
7 arrangement which the Commission finds the most appealing. Accordingly,
8 the Commission believes it is appropriate that the counterfactual it
9 adopts be expressed in general terms and that these terms describe what
10 is pragmatically and commercially likely in the absence of the proposed
11 arrangement. The kind of counterfactual we've been discussing involves
12 the assumptions that A) the minister wouldn't act in the interim and B)
13 the industry would be able to reach a compromise or agreement along the
14 lines suggested. I'd suggest that it's unsafe to assume that because of
15 the industry's ability to pick up the points made in the draft
16 determination in relation to the conditions, it's unsafe to assume from
17 that ability that the kind of changes that you may have in mind could be
18 picked up.
- 19 **MS REBSTOCK:** I don't have any changes in mind. I'm trying to explore the
20 possibility of what you would do in light of a determination that
21 indicated whatever concerns it indicated. But - and I have no difficulty
22 with what you've just said but nevertheless we still have to find a
23 counterfactual that we think is most likely, I'm sure you're aware from
24 the Commission's experience we do see applicants resubmit, particularly
25 if there's a close overlap between the benefits and the detriments
26 because it clearly indicates that there's, you know, that there's
27 potential there and so I'm speaking from the experience of the
28 Commission. We do see applications coming back. Not when it's an open
29 and shut case, but when there's a close overlap you will be aware that it
30 does happen.
- 31 **MR CAYGILL:** What the industry might do relatively cheerfully if it weren't
32 operating in an environment where the Government has said this is what we
33 want you to achieve within an expeditious timeframe, in other words if it
34 was a private applicant able to take a commercial decision absent a
35 political timeframe, may very well be different.
- 36 **MS REBSTOCK:** Sure, thank you.
- 37 **CHAIR:** Just leave on the table the point that all the work that's been done so
38 far, again without trying to read what a Minister would think, it would
39 seem to me that to dispense with all that and start completely again for
40 a Crown EGB may not be the most use of people's time.
- 41 **MR CAYGILL:** Indeed the applicant has assumed - we haven't engaged in this as an
42 exercise - let's spend a couple of years designing something that may
43 well be a complete waste of time if something completely different
44 happens. I don't doubt at all that much of our design would find its way
45 into the Crown EGB indeed that's precisely why, it is part of our comfort
46 with that as the counterfactual. But it is the Crown EGB, albeit using
47 our design that becomes the counterfactual, not some modified version of
48 our own rulebook.
- 49 **CHAIR:** I see your point. Any other questions? Mr Adam?
- 50 **MR ADAMS:** Just one point you might be able to help me with, the others might
51 have thought of a solution. The key player in a sense in determining the
52 counterfactual is of course the Minister, but we're likely to be making a
53 decision in the period between the end of one Parliament and the
54 commencement of another one where we at this stage don't know who the
55 Minister, or who the Government is going to be. How should we address
56 that in reaching a conclusion on this?
- 57 **MR CAYGILL:** Two points occur to me sorry.
- 58 **MR KOS:** We discussed exactly that yesterday afternoon so I think we can answer
59 that. You'll understand why we discussed it yesterday afternoon.
- 60 **MR CAYGILL:** Firstly I think it's relevant that the framework against which the

1 Government policy statement was made, the - it was made contemporaneous
2 with a bill which, although modified was not modified in significant ways
3 in terms of its basic design, I think it's relevant that, as Stephen
4 indicated, that the fundamental principles there were supported by a
5 majority of the Parliament. Secondly, it seems to me that, so I think
6 the Commission's entitled to draw some come forth from that, and then the
7 more basic point must surely apply that the Commission must apply the law
8 as it stands at any point in time not only is the applicant entitled to
9 the benefit of that everybody else is equally bound by that, in other
10 words.

11 **CHAIR:** You can have no doubt we'll do that.

12 **MR CAYGILL:** The framework, including the status of the policy statement in
13 terms of section 26 of the Act must still be relevant, not only have you
14 got no choice about it, but that is what you should do.

15 **MS BATES:** Can I just go back to the differences between Crown EGB and industry
16 EGB that we were discussing at the end of the last section. You seem to
17 be putting to us that the Crown EGB would be more susceptible to lobbying
18 through the Minister by various industry players, is that correct?

19 **MR KOS:** Yes, because he has a much more dictatorial power so is therefore much
20 more important to influence.

21 **MS BATES:** Would you say the same could be said of consumer groups and their
22 ability to lobby the Minister, would they have the same ability to lobby
23 the Minister because of that as would various industry players?

24 **MR KOS:** Under the Crown EGB model?

25 **MS BATES:** Yes.

26 **MR KOS:** I would have thought so.

27 **MR CAYGILL:** Certainly I can't, they're not inhibited from doing that in any way
28 and many of them I think are very experienced at doing that.

29 **MS BATES:** Would that be a concern to the applicant?

30 **MR CAYGILL:** It's not - I think it's relevant - the only attitude we have about
31 that goes to our assessment of the benefits and detriments of our
32 application as against the counterfactual. That's the only attitude we
33 have about that is thinking through the implications in terms of
34 measuring public benefit and detriment.

35 **MS BATES:** It seems to be your view that it's better to have an industry EGB
36 because it's one move from the Minister as it were, is that right?

37 **MR KOS:** Yes and also because it's in our submission a more efficient decision-
38 maker, it embodies more inherent knowledge. No doubt however it will
39 have some - consumers presumably will talk to it. Indeed it's not
40 inconceivable that members of that particular body will have a consumer
41 background.

42 **MS BATES:** Just coming back to the power to direct which is 172.Z.A, I want to
43 ask you about this because it seemed to me that you were indicating that
44 the Minister might be influenced to use his or her power to direct in a
45 somewhat arbitrary way and I'd just like to draw to your attention, as
46 you no doubt know, that the power to direct under that section is fairly
47 circumstance described, it's not an open ended power to direct, is it?

48 **MR KOS:** No, but in the sense that there's a process that's set out in that
49 particular provision.

50 **MS BATES:** It's not just a process, it's direct, may direct to give effect to a
51 Government policy, and to make a direction that's consistent without
52 comes to be achieved by EGB or objectives, but particularly in subsection
53 4, it says direction to EGB must not require EGB in respect of a
54 particular person to make a particular direction or to do or refrain from
55 doing a particular act, or to bring about a particular result. So, there
56 is - all I'm trying to point out is it seems to me that from this section
57 that there are some real constraints on the ability of the Minister to
58 direct Crown EGB's, I'll just ask you to comment on whether I'm right in
59 this view or not.

60 **MR CAYGILL:** Frankly, my reaction is the world's Government policies, outcomes,

1 objectives, are all wide words. I don't mean vague but I do mean wide,
2 that this is a very broad power of direction. It's at the - it's a power
3 that lies with an individual Minister not the Cabinet, no doubt the
4 matter might be discussed in the Cabinet, but it's not a power exercised
5 by way of ordering council. The direction needs to be --

6 **MS BATES:** Needs to be consistent with, it says it needs to be consistent with
7 the statement of Government policy as set out in section 172.Z.K doesn't
8 it?

9 **MR CAYGILL:** Yes, it says that. But that statement itself can be changed from
10 time to time.

11 **MR KOS:** By Minister alone.

12 **MR CAYGILL:** It's - I mean I don't have a problem with the language but I think
13 the Parliamentary record --

14 **MS BATES:** You don't see it as particularly constraining is that what you're
15 saying.

16 **MR CAYGILL:** No - yes, that's exactly what I'm saying, and I think the
17 Parliamentary - I think the record of debate in relation to the bill
18 suggested that it was seen in Parliament as a wide power, not drawing
19 conclusions from that, but simply it's a wide power not a narrow power.

20 **MS BATES:** Though just coming back to it, it does emphasise particularly in
21 subsection 2, the need to be consistent with the purpose of this part of
22 the Electricity Amendment Act.

23 **MR CAYGILL:** Yes, that's absolutely so.

24 **MS BATES:** What I suppose I'm saying Mr Caygill is it doesn't seem to me that it
25 necessarily allows a Minister to behave in an arbitrary way that the
26 Minister has to go back to the legislation to - in order to decide
27 whether to give particular directions or not.

28 **MR CAYGILL:** Arbitrary is a tough word.

29 **MS BATES:** I suppose so.

30 **MR CAYGILL:** In pejorative in some respects but I think it is an appropriate
31 word here. This power is confined by its language but little else. This
32 is not a power that can be exercised only after consultation with the
33 Cabinet, it's - the direction needs to be tabled so it can't be exercised
34 secretly but it is wide. If I can draw a contrast for you. There is in
35 the rules a provision which will require a proposed change of rules to be
36 submitted for a vote if it, and I'm searching for the language here, if
37 it impacts adversely on any member of the industry, I haven't got the
38 phrase exactly

39 **MR WILSON:** It's a material financial disadvantage.

40 **MR CAYGILL:** Now, we needn't debate, you know, why that rule is couched in that
41 way. Let's just observe that the equivalent of a rule change which could
42 materially financially disadvantage a member can come about under - in a
43 Crown EGB context at the behest of a ministerial direction. Now, that's,
44 you know, not if it's singled out a particular participant, that would
45 contradict the provision to which you drew attention, but if it affected
46 more than one it would not contradict subsection 4 and I mean it is
47 plainly possible for the market to be redesigned as a consequence of
48 ministerial direction to the industry's financial - to the financial
49 disadvantage, whatever the --

50 **MS BATES:** There is a constraint of this piece of legislation itself, has to be
51 consistent with the legislation.

52 **MR CAYGILL:** Yes.

53 **MS BATES:** So it's not going to go off on a completely different tangent.

54 **MR CAYGILL:** No, the purposes need - it needs to be pursuant to the purposes
55 achieved by the - addressed by the legislation, but the legislation is
56 very wide. There are many ways in which wholesale markets can be
57 designed or transmission rules can be constructed or quality standards
58 can be set that would have very significant consequence on participants,
59 including consumers, which would be procedurally fair but nevertheless
60 the word arbitrary could easily be used.

- 1 **MS BATES:** You think radical change is more likely under a Crown EGB than an
2 industry EGB do you?
- 3 **MR CAYGILL:** No, I don't assert that. I assert that radical change is more
4 possible in potentially arbitrary directions under a Crown EGB. The
5 result is that there is a greater degree of potential risk and a reduced
6 degree of predictability.
- 7 **MS BATES:** Its as though you said earlier you thought the Crown EGB would be
8 likely to be more conservative than an industry.
- 9 **MR CAYGILL:** In some respects and I think particularly of some quality issues.
10 But I mean - it's simultaneously possible for it to be arbitrary and
11 reluctant to change. If that sounds like a contradiction then I'm stuck
12 with it, but I think though both those things are true.
- 13 **MS BATES:** I'll move away from that particular section now. I just wanted to
14 explore that with you.
- 15 **MR PALMER:** It should be remembered that that's a formal channel of influence
16 it's not an exclusion of informal channels of influence between the
17 minister and the Crown EGB.
- 18 **MS BATES:** No, it's not but it's a mechanism whereby the Minister then puts a
19 decision through to the EGB isn't it?
- 20 **MR PALMER:** It's a mechanism that can be used but influence can be more informal
21 as well, in fact the threat of using a formal mechanism of influence can
22 be very effective to influence that kind of entity towards going in a
23 certain direction.
- 24 **MS BATES:** But you think that's more likely the informal channels are more
25 likely with a Crown EGB than an industry EGB do you?
- 26 **MR PALMER:** I wasn't making that assessment, just pointing out there are an
27 array of ways that the Minister can affect it.
- 28 **MS BATES:** Would you agree that can happen in both scenarios?
- 29 **MR PALMER:** Within the industry EGB there's certainly a tension between
30 industry and self-regulation involvement with Government but in the Crown
31 EGB the same tension doesn't exist, the accountabilities to the Minister.
32 So, you can get influence in both but it's much more likely to be
33 political decisions being made by the Crown EGB than an industry EGB.
- 34 **MS BATES:** Do you think that's why the Minister actually prefers not to have a
35 Crown EGB?
- 36 **MR PALMER:** The Minister is in a sense tying his hands, or not putting his hands
37 into the fray, based on the assessment that David referred to before that
38 that's the way the Government sees the industry being most efficiently
39 run, is by the Government keeping its hands out.
- 40 **MS BATES:** Okay, I want to turn to another topic which is the composition of
41 the, what would be the likely composition of the Crown EGB as opposed to
42 the industry EGB. I see that as possibly being a difference, but I'd
43 just like to hear what you have to say about that.
- 44 **MR CAYGILL:** I think that it is unclear that there would necessarily be any
45 difference. The rules in the application that's been submitted state the
46 range of skills, experience, knowledge, that needs to be available in the
47 list of potential board members who are submitted to a vote. There is
48 nothing in the legislation in relation to a Crown EGB which requires that
49 a more representative structure be created. Indeed nothing that
50 requires, that sets up even a formal right of norm nation. I assume from
51 that that the Government --
- 52 **MS BATES:** What I'm driving at here, and I can't remember the particular
53 submissions, but there's a flavour coming out in some of them that a
54 Crown EGB wouldn't attract the sort of level of industry expertise that
55 an industry EGB would. That's really what I'm trying to explore, whether
56 you get the same line up of people on a Crown EGB as you would on an
57 industry EGB.
- 58 **MR CAYGILL:** I can only say that I think that there may be some people who would
59 be less comfortable working in a Crown entity context as compared to an
60 industry body, albeit one that, by definition, that they need to be

1 independent of the industry or else they don't qualify in the first
2 place.

3 **MS BATES:** You don't really - would I be correct to say you don't really think
4 there'd be any great difference in the composition of the board of one to
5 the other?

6 **MR CAYGILL:** I think I'm - the difference that is stark is the difference in
7 accountability. I'm not comfortable - I think the way you put is exactly
8 right. It's not obvious there would be any great difference as between
9 the two. All we know is that there's no specification around the
10 composition of the board, save that they are all appointed by the
11 Minister.

12 **MR KOS:** There's no particular specification in relation to either model, so to
13 that extent that's right, the industry EGB, there's a set of skill sets
14 that are set out in the rulebook. But clearly you're not going to have
15 people who necessarily will have all of those. There are no particular
16 skill sets set out in the second schedule to the Act, except that the
17 person has to have, in the Minister's opinion, appropriate skills and
18 experience.

19 **MS BATES:** Well, then you can get down to the difference in accountability. Can
20 you just summarise that again, the difference in accountability.

21 **MR KOS:** It comes from the fact that in relation to the Crown EGB the member is
22 appointed by the Minister and is removable by the Minister at entirely
23 his or her discretion. "may be removed from office by written notice to
24 the member, copy to the EGB." the process in the case of the industry
25 EGB is quite unlike that, where you have a process of formal election and
26 you do not have the power of a single individual, let alone a political
27 individual to remove.

28 **MS BATES:** I see, so the members would feel more accountable to the Minister
29 because the Minister has the power to do away with them if necessary.

30 **MR CAYGILL:** And appointed them in the first place, I think that's very clear.

31 **MR PALMER:** Your point about the relative expertise also touches on another
32 issue which is the decision-making in the two models, and the industry
33 EGB rule changes for example are voted on by the industry participants so
34 their knowledge comes through as part of that voting process whereas in
35 the Crown EGB the recommendation to the Minister comes from the people
36 who are on the Crown EGB. So, that's an important difference in terms of
37 expertise because it's more dispersed in the industry EGB model.

38 **MS BATES:** Thank you.

39 **CHAIR:** If you get a hard-nosed chairman of a Crown EGB who might communicate
40 with the Minister only occasionally. That's only a postulation, I was
41 not taking a view on that.

42 **MR CAYGILL:** If he or she can get away with it, communication being two-way.

43 **CHAIR:** We're at 1.30, I see price fixing is next. It's probably better we
44 break for lunch, so at least we can not interfere with people's digestion
45 schedules. If we start again at 1.30 on price fixing. I'll ask the
46 staff to make sure that - we just have to plan that we work over today as
47 far as you're concerned and liaise with other parties so that we can get
48 all of this heard with good time to debate it all.

49 **MR KOS:** We're entirely in your hands on that. We didn't see a need for us to
50 present at length on counterfactual price fixing regarding principles.
51 We recognise that, of course, the Commission would have questions and
52 we're happy to spend as long as you want to answer those.

53 **CHAIR:** I think this morning given that one issue leads to another, and we're
54 looking at having the ability of Mr Caygill who's been in the process
55 since it started way back, I think that background has been important
56 from the Commission's point of view, so we're taking a bit more time than
57 we'd estimated, but let's break now. I just make the point we'll be
58 asking other parties if we can just move things back a little so that
59 they also have time to explain in detail where they're coming from. So,
60 we'll come back at 1.30ish.

1 (Lunch adjournment from 12.35 to 1.35 pm)

2 **CHAIR:** We'll resume. I think the next item on Mr Kos's list is price fixing.
3 So, throw it back to you please.

4 **MR KOS:** Desperately tempted as we are to re-engage on the topic of
5 counterfactual, some good ideas we had over lunch, we thought we might -
6 but we think in the end, we think the Commission might have taken on
7 board some of the points we made. So, we'll see and no doubt it will
8 appear in the course of discussion. If not we'll try again. So, with
9 that warning --

10 **MS BATES:** Do you want to give us a test Mr Kos?

11 **MR KOS:** No. I've left my jacket on in case I need to rapidly depart. We'll
12 move to price fixing. This is in a sense a - it's not an academic point,
13 but it's a point perhaps of less direct relevance. We recognise the
14 necessity for authorisation, but there are some aspects of the draft
15 determination, finding that the proposed arrangement breached or might
16 breach section 30 in a number of respects, which we have contested in our
17 submission and we've set out quite a detailed annex B. We don't really
18 want to say much in addition to that. Would it be helpful if I took you
19 just quickly to 2.7 of the notes, which is a summary. I've really
20 already given the first part of 2.7.

21 But just to note that the adverse findings in relation to wholesale
22 pricing mechanism, transmission pricing methodology and common cost
23 allocation are what we contest and we contest it in part because if those
24 conclusions are sustained in the final determination and that will have
25 significant consequences, not just for this industry, but for many other
26 price determining processes in a whole variety of industries and cost
27 allocation mechanisms in the wider economy. We have submitted that the
28 correct test, as we note at key point B, is the Commission's earlier
29 decision in the insurance council decision and there what the Commission
30 said was, and I'm quoting from paragraph 5.1 of our formal submission on
31 the draft determination:

32 "the terms fix, control and attain are synonymous with an
33 interference with the setting of a price as opposed to allowing such a
34 price to be set in response to changes in supply and demand for goods and
35 services".

36 I thought it would also be useful at this juncture just to go to
37 the quote from Professor Koss, no relation. In fact it's not even the
38 same spelling. At paragraph 5.7 of that submission, and what Professor
39 Koss said in his book "The Firm, the Market and the Law" - the previous
40 submission, it's appendix B, this is the quote:

41 "All exchanges regulate in great detail the activities of those who
42 trade in these markets; the times at which transactions can be made, what
43 can be traded, the responsibilities to the parties, the terms of
44 settlement etc, and they all provide machinery for the settlement of
45 disputes and impose sanctions against those who infringe the rules of the
46 exchange. It's not without significance that these exchanges often used
47 by economists as examples of a perfect market and perfect competition are
48 markets in which transactions are highly regulated and this is quite
49 apart from any Government Regulation there may be. It suggests - this is
50 the key passage. It suggests I think correctly that - for anything
51 approaching perfect competition to exist an intricate system of rules and
52 regulations would normally be needed".

53 So that is the background to the submission we make on the
54 application of section 30 to wholesale pricing, transmission pricing and
55 common cost allocation. In relation to the wholesale pricing provisions
56 of the rulebook, our submission is that that mechanism determines the
57 spot price, spot dispatch price for electricity and members are still
58 able to trade at any price they choose, including via contracts for
59 differences. We make the point that price finding in our submission is
60 not price fixing. It doesn't involve a transactional or a structural

1 distortion of price competition and we refer at the bottom of page 12 to
2 Professor Koss, that I've just read out.

3 We make the point that if, at the top of page 13, that if wholesale
4 pricing mechanisms in this rulebook breach section 30 then in our
5 submission so will trading exchanges, auctions and tender processes.
6 That's a very succinct summary of the position on that. James Palmer
7 will comment quickly on D and E.

8 **MR PALMER:** In relation to D one of the functions of the rulebook is to divide
9 up various costs. For example the costs of service provider, such as the
10 system operator, or the pricing and clearing managers, are in a sense
11 jointly acquired by the members of the rulebook and those costs are
12 allocated by the rulebook. Also costs in relation to ancillary services,
13 services which are required to maintain frequent and voltage on the grid
14 are divided between the members.

15 The Commission's test from the draft determination at paragraphs
16 143 to 145 seems to be that any allocation of costs between competitors
17 in relation to a service for which they compete, or which they re-supply
18 in competition with one another breaches section 30. We submit that such
19 an approach which makes unlawful many common business arrangements and
20 perfectly efficient business arrangements cannot have been intended by
21 Parliament and I'll give you a couple of examples.

22 The first is any industry forum where costs are shared between the
23 members and where the members compete with one another could be seen as
24 breaching section 30, to takeaway outlets who compete vigorously but
25 decide to share in the expenses of a delivery van could be seen to breach
26 section 30. Another example is the case of a vertically integrated
27 company which has control over a bottleneck facility, where it is
28 required, and it may well be required under section 36 of the Act, to
29 give access to that facility to other competitors to allow them to
30 compete in the downstream market. The company could find itself in a
31 position where it would breach section 30 by providing access to the
32 bottleneck facility because it's a cost sharing of a service which the
33 company's re-supply in competition with one another, yet it would breach
34 section 36, if it did not provide access.

35 It is our submission that those results are clearly against the
36 intention of Parliament and that the interpretation given to section 30
37 must therefore be incorrect and we would submit that the Insurance
38 Council test of whether there is an interference with the normal forces
39 of supply and demand is the correct test to apply in relation to common
40 cost allocation as well.

41 In relation to E, transmission pricing methodology, the two points
42 there are that a transmission pricing methodology is essentially a cost
43 allocation mechanism. Based on the submissions that I've just made,
44 there's no reason to think that it's in any way inappropriate, certainly
45 in the abstract, a particular pricing methodology would only be
46 inappropriate if it interfered with supply and demand in some way. So a
47 pricing methodology shouldn't be per se unlawful, and certainly the
48 process in F doesn't contain a particular pricing methodology, it's one
49 step removed, it's the process for determining a pricing methodology.

50 So, given that remoteness it's just a process, it's not in itself
51 fixing, controlling, maintaining prices in anyway. So, for those reasons
52 and the reasons given by Stephen we would submit that the wholesale
53 pricing mechanism common cost allocation and the transmission pricing
54 methodology are all compliant with section 30. As Stephen said it's, in
55 a sense, an academic exercise, although important, but it's academic to
56 this application because we do accept that the pricing in relation to
57 non-members under section - under section 9 of part A does breach the
58 Act, so the Commission certainly has jurisdiction. There's no
59 jurisdiction argument but it is important for the industry and the wider
60 economy.

1 **CHAIR:** Thank you.

2 **MS BATES:** I think I'll be asking the main questions on this section which are
3 actually compiled in consultation, but for efficiency sake one person has
4 been asked to do them, but there may well be follow-up questions from
5 staff, points that I might miss and the other members of the Commission
6 may well have their own questions as well. We agree with you to some
7 extent about the point you make about it being academic, but we do think
8 it is an important question of principles and therefore we intend to look
9 at it carefully. So to whom should the questions be addressed to you
10 Mr Kos?

11 **MR KOS:** Through me and I'll draw James in as required or others.

12 **MS BATES:** Perhaps, it's a pretty facile starting point, but the starting point
13 is what do you think is the purpose of the spot price market?

14 **MR KOS:** It is a price finding purpose. It's a price that clears the market of
15 which generation is dispatched.

16 **MS BATES:** You'd see it as a process whereby price is discovered?

17 **MR KOS:** Yes.

18 **MR PALMER:** Similar to other price discovery processes like auctions or tender
19 mechanisms which have a series of rules around them. So in that sense
20 they constrain the behaviour of the participants because there are rules
21 which are used to discover a market price. That's not uncommon, that's
22 not unusual, but there's no restriction on the offers or bids that can be
23 made by market participants, prices are adjusted in terms of supply and
24 demand. Importantly in relation to the wholesale spot price, through
25 contracts for differences, people can actually contract at a different
26 price. The spot dispatch price is just a spot dispatch price.

27 **MS BATES:** Have you told me the purpose of the spot dispatch price?

28 **MR PALMER:** It finds a price where the supply schedule, which is constituted by
29 generation offers to the market, clears with real time demand.

30 **MS BATES:** So it's the intersect isn't it, when it defines one price from the
31 offers and bids process.

32 **MR PALMER:** It defines a price at each point on the grid, each off-take node or
33 each in-take node, so roughly 246 prices per trading period.

34 **MS BATES:** But one price emerges from the various bids and offers.

35 **MR PALMER:** The 246 price is every half hour, but those prices are all related
36 to each other through the different transmission constraints and losses.
37 So, it's in a sense one price, but it's different in different places.

38 **MS BATES:** I do understand that. What effect do you think it has on the price
39 stability generally in the electricity market?

40 **MR PALMER:** Over time or? Stability --

41 **MS BATES:** Over time.

42 **MR PALMER:** What kind of timeframe? Do you mean short-term stability?

43 **MS BATES:** Long-term stability.

44 **MR MURRAY:** The price reveals information against which people use to plan for
45 the future and so they'll act on that information.

46 **MS BATES:** Maybe a better way of asking it is does it affect, you think it does
47 affect price stability in the market.

48 **MR PALMER:** Whether or not prices are stable will depend on how supply and
49 demand for electricity fluctuates. It's in the - a mechanism itself
50 which causes stability or instability. It generates prices which respond
51 to changes in supply and demand.

52 **MR KOS:** Which I think actually is --

53 **MR TAYLOR:** Peter Taylor, General Counsel of the Commission. Just on this
54 question of stability and going back to the question of the purpose of
55 the spot price. Take us back to an early comment Mr Caygill made this
56 morning that the set of rules is necessary in the electricity market.
57 So, really to get behind the question as to why is it necessary to have
58 this market. What would be the situation without it? What would happen
59 to electricity prices without having this body of rules to determine the
60 price?

- 1 **MR MURRAY:** You'd need some other mechanism for coordinating supply and demand
2 at a particular point in time and the mechanism that was used prior to
3 the wholesale market coming into force was vertical or horizontal
4 integration for essentialised control. That is one entity, ECNZ
5 controlling the operation of different plants at a particular point in
6 time.
- 7 **MR TAYLOR:** And in relation to the operation of contracts, talking about, you
8 can have financial contracts which have prices which may or may not
9 reflect the spot price market, there are prices determined between two
10 parties. Again, why is it necessary to have a spot price market if you
11 have bilateral trades which can operate?
- 12 **MR MURRAY:** It's not strictly necessary. In the pre-wholesale market days when
13 there was ECNZ as a single entity it entered into long-term supply
14 contracts with its customers which were referenced off first a set price
15 and more latterly over its estimate of what its marginal costs would be
16 at a particular time in the future.
- 17 **MR PALMER:** Although if there was no spot market there would have to be a
18 mechanism for determining dispatch order which is the other function of
19 the pricing mechanism in the rulebook to determine the supply schedule
20 for the order of dispatch generators. One of the characteristics of the
21 electricity market which makes it different from other markets is that
22 supply and demand have to be balanced in real time, otherwise you have
23 frequency and voltage effects and that's quite different to the market
24 for tomatoes, where they can sit there for a while. It has to be
25 balanced in real time so, if you didn't have a spot price you'd need some
26 other mechanism for determining dispatch.
- 27 **MR WILSON:** With multiple generators in a market it's - they could have
28 contracts with purchasers, they would - it would be impossible for them
29 to co-ordinate their supply with their purchaser's demand in real time so
30 they would need to have some sort of formal market between the
31 generators, presumably to actually trade differences between what they
32 were actually contracted to deliver and what they actually delivered and
33 what their customers were contracted to buy and what they actually
34 bought. So, that rapidly devolves towards some sort of formal
35 arrangement for trading which becomes a spot market.
- 36 **MS BATES:** If I could just come back. The price determined by reference to
37 whatever set of rules is obviously going to be affected by that set of
38 rules. So, you may get a different price under one sort of mechanism
39 than you would under another mechanism, is that right?
- 40 **MR PALMER:** You may well get a different price depending on whether you use an
41 auction mechanism or a tender mechanism. The mere fact of a different
42 price doesn't mean that prices are being fixed or that supply and demand
43 is being interfered with.
- 44 **MR KOS:** Back to the point I made before about whether you have a transaction
45 or a structural distortion, and also to the Koss quotation about the
46 necessity for rules to actually create perfect competition.
- 47 **MS BATES:** I can understand what you're saying about the necessity for
48 mechanisms, I can understand that, but it seems to me invariably you get
49 to a point where it is an integral part of the rules, the rules form an
50 integral part of how the price is arrived at.
- 51 **MR PALMER:** But the question at the end of the day should be, and does that
52 mechanism interfere with the normal forces of supply and demand in some
53 way. Is it a distortion, or is it just market price discovery?
- 54 **MS BATES:** And your answer to that seems to be that because such a mechanism is
55 necessary to operate the market efficiently then there is no such, is
56 that - have I got it right?
- 57 **MR PALMER:** It is because if a market price finding mechanism such as an
58 auction, an exchange, spot market price here, if that was unlawful then
59 any price finding mechanism would be unlawful. Dunbar Sloan would be
60 made unlawful.

- 1 **MS BATES:** Not necessarily, because it has to be an agreement between the
2 competitors so you're not always getting --
- 3 **MR PALMER:** If two dealers were competitive bidders and agreed to be part of the
4 arrangement with Dunbar Sloan.
- 5 **MR TAYLOR:** I think there's a number of points we can make in relation to
6 auction process and tender process. Just coming back to the argument.
7 The question is whether you have a particular mechanism that either
8 discovers or finds or determines a price, and you have another question
9 as to whether that process is necessary or whether it's there for
10 efficiency process, or a competitive process. You can have two stages of
11 the analysis and what I think I'm hearing from your analysis is that
12 first of all you have to look to see whether this is a - has a
13 competitive outcome or it's necessary, it has an efficiency outcome
14 before you look at the issue as to whether it's - falls within the ambit
15 of section 30.
16 I just wanted to explore that a little bit as to whether that is
17 your position.
- 18 **MR PALMER:** It's not quite the way I'd put it. Market prices aren't lying
19 around, you need a process to discover them. The way the necessity
20 argument fits in is that Parliament presumably didn't intend to make
21 unlawful a whole class of those processes which are used to find market
22 prices. I think that's where necessity comes in. The simple test for
23 section 30 which was used in Insurance Council and the applicant
24 supports, is to look at a - any price finding process such as this and
25 ask the question of whether or not supply and demand are allowed to
26 operate freely within the process, or whether there is an interference
27 with the forces of supply and demand.
- 28 **MR TAYLOR:** Just on that point, that depends on the nature of the rules. I mean
29 if you have a set of rules, and you take a very extreme example, you have
30 a price finding mechanism which is subject to chance, subject to the
31 roulette wheel, that can also find a price. Whether that finds what you
32 would describe as a market price is another question. Whether it's a
33 market price depends on the particular rules that you formulate to
34 actually discover whether that replicates a true market price or not, and
35 whether you have just, really just found another methodology of
36 discovering a particular price. You can then say whether that fixes a
37 price, it determines a price and then go on to the next stage to see
38 whether that's a competitive approach or an efficient approach or not.
39 So, just, market price just depends on what the particular rules say
40 doesn't it?
- 41 **MR KOS:** It's almost the opposite isn't it? Isn't it more likely that a market
42 is the free interaction of participants, as far as is possible. But in
43 some commodities you need a framework of rules in order to create that
44 interchange, and in this particular commodity you do need that because of
45 the technical aspects that have been spoken about, as well as, well in
46 fact principally the technical aspects.
- 47 **MS BATES:** You mean not because there needs to be an exchange of knowledge
48 between supply and demand, is that what you're getting at?
- 49 **MR KOS:** No, it's an exchange between supply and demand, but there are
50 technical restraints on the ability to deliver, which meant for instance
51 that all the models we've talked about, apart from this current dispatch
52 model we're working on, seem to have components of price fixing, or
53 limiting supply, when you had simply ECNZ dispatching or other
54 mechanisms. This particular mechanism is intended to be the most
55 effective way of finding a market in which the rules have the least
56 influence.
- 57 **MR TAYLOR:** The least influence, that predicates they have some influence.
- 58 **MR KOS:** In a contextual sense they do. The question is - I'm not sure you can
59 take rules away and say they have no influence at all in a market but the
60 presence of rules is not inconsistent with the pure competitive outcome.

- 1 **MR TAYLOR:** I can appreciate they may not interfere with the pure competitive
2 outcome, however that's particularly described, but again is that the
3 second stage of the analysis is to whether that is a competition
4 analysis. These things may be extremely good, may be extremely necessary
5 in a particular market. But that's an assessment that has to be made to
6 see whether there's a benefit and a detriment in having this particular
7 process rather than compared to some other process. The rules themselves
8 in some way are going to interfere or determine or define price.
- 9 **MR KOS:** No, not at all, because to create the exchange at all, particularly
10 with a commodity like this, you need a series of rules, can we accept
11 that premise? You will need some rules in order to affect the exchange
12 these commodities, with this commodity. You cannot trade electricity
13 without a rule.
- 14 **MR TAYLOR:** In order to effect exchange because if there's some physical
15 restraints in relation to supply that's a preliminary question or a
16 different question as to whether you need those particular rules to
17 determine the price of that commodity.
- 18 **MR KOS:** Is it?
- 19 **MR PALMER:** Going back to Koss and thinking about what we regard as close to
20 perfectly competitive markets, I mean you might think of foreign exchange
21 markets, share markets, some commodity exchange markets. They're all
22 intensely rule bound markets. The rules are required in order to allow
23 supply and demand to work, to have supply and demand aggregated. It's
24 true that for a particular marketplace a slightly different set of rules
25 could produce a slightly different price that's entirely possible. That
26 in a sense means the particular set of rules that you choose will have
27 some influence on price, but it cannot have been intended by Parliament
28 that every such arrangement is per se unlawful and requires an
29 authorisation to proceed. That has never been suggested in any of the
30 cases referred to by the Commission in the draft determination. And
31 that's an important point, that the draft determination is based on the
32 idea that the law had changed since the NZEM decision. But as we go
33 through in our annex, none of the decisions referred to change the law at
34 all, they're all entirely consistent with the NZEM decision.
- 35 **MR MURRAY:** This may be going back in history a little bit, as you mentioned
36 earlier there are any number of markets you could think about to
37 establish what a price might be in a competitive way, I appreciate that.
38 But if people could just shed a little bit of history on why the market
39 has taken the shape it is. Essentially on the demand side people put
40 quantity bids in, and on the supply side people put price and quantity
41 bids in, and that's what you've ended up with, as opposed to Dutch
42 auctions or sealed tenders or God knows what. I was just wondering in
43 terms of the market design of this market, how did you get there and why?
- 44 **MR PALMER:** I think it's quite correct to say that demands are put in quantity
45 only bids. There's a process ahead of the finalisation, forming of the
46 spot price where both the demand side puts in both price and quantity
47 bids and the supply side puts in price and quantity offers. That
48 information is used to signal likely prices ahead of time. The price, at
49 the real time price people pay is determined on demand that they take at
50 that precise moment, crossing the supply offer at that moment. The
51 difficulty in an electricity market with establishing a price ahead of
52 time is that many things change very quickly across the integrated system
53 and the spot price is intended to try and find a price that balances
54 supply and demand at each point on the grid at a single moment, where the
55 moment here is taken the trading period of a half hour so, it's averaged
56 over one half hour.
- 57 **MR TAYLOR:** I hear your point, but at the end of the day on the price side it's
58 essentially the supplier's prices at actual demand when it materialises.
- 59 **MR MURRAY:** That's correct.
- 60 **MR TAYLOR:** Just to come back to the design of the rules and you can have rules

- 1 designed in any particular way, and design of those rules will impact on
2 price in some way. If you change the nature of the rules you will change
3 how the price is determined, you can actually change the amount of the
4 price as a result. Would you accept that?
- 5 **MR PALMER:** Possibly I'd say that in the general context that there are
6 different sets of rules which would be consistent with section 30 which
7 could produce different prices in a market.
- 8 **MR TAYLOR:** Subject to the qualification, if the rules here were improved and
9 there's been some discussion before about the rulebook is a dynamic
10 rulebook and changes can be brought through, there's been changes in the
11 development of the wholesale market from ECNZ decision and the rules
12 formulated there through to NZEM. As those rules evolve, they will
13 change the trading nature of the market, presumably would it be right to
14 say that they would also influence how realistic the price is or how
15 comparable the price is to normal supply and demand.
- 16 **MR KOS:** Can you explain what you mean by normal supply and demand. That was
17 the point I was trying to make before. In this particular context you
18 have rules which assist you not only to trade the complex physical
19 commodity you're dealing with, but also which help you find a price. The
20 submission that we are making is that the price finding element of this
21 is a natural feature of this particular commodity, the trading of it, and
22 does not involve an interference or a distortion but is inherent.
- 23 **MR TAYLOR:** Can I just pick up on the point, I think it's an interesting
24 question about what is normal supply and demand because normal supply and
25 demand depends on the conditions in which supply and demand had taken
26 place. So, what is normal is a fairly relative term is it not? So that
27 if, again going back to my point. T the moment, the rules are designed
28 in a particular way where generators have to put in their offers and they
29 can't change those offers two hours prior to actual trade taking place.
30 So, if that rule, for example, was changed, would that have an influence
31 on price?
- 32 **MR WILSON:** Potentially it must have, yes.
- 33 **MR PALMER:** Or if you went from half hour prices to quarter hour prices that
34 would change price in a sense for the second half of the half hour
35 period, it could be a different price. But the fundamental point is if a
36 system which doesn't otherwise interfere with supply and demand could be
37 unlawful, then the Stock Exchange has to stop as soon as the draft
38 determination comes out.
- 39 **MS BATES:** Not necessarily, they're not competitive.
- 40 **MS REBSTOCK:** It's on legislative support. Some markets have their own
41 legislative support and they have them because for whatever reason they
42 have characteristics that lead to the need for a regulatory environment
43 to support them. I don't think that's necessarily the right correlation.
44 But if you're in a market, if you say that you can change the rules and
45 you get different, a different price emerging from the normal interaction
46 of supply and demand.
- 47 **MR PALMER:** It's not a price which is different from the normal interaction of
48 supply and demand.
- 49 **MS REBSTOCK:** You're constraining the market with a set of rules that yields
50 different answers, depending on those rules and so what is the normal
51 interface between supply and demand? If the rules simply allowed the
52 normal interaction of supply and demand to find an answer, I don't see
53 why the answer will change from one type of arrangement to another. If
54 the purpose was simply - if it was always aimed at revealing a price from
55 the interaction of supply and demand --
- 56 **MR PALMER:** It changes in a de minimus sense. It's at the intersection of
57 supply and demand, but there's no magic number. The number of decimal
58 places that you put the price to affects the price.
- 59 **MS REBSTOCK:** So how much do the rules have to constrain the price before it
60 breaches section 30?

- 1 **MR PALMER:** Difficult to answer in the abstract. The test is the Insurance
2 Council, whether it's an interference rather than allowing the free play.
- 3 **MR MURRAY:** The two hour rule may provide a good example of that. The two hour
4 rule was introduced or maintained for system security reasons.
5 Transpower was concerned that it needed some period of time to plan the
6 system once it knew what the generator offers were and therefore their
7 likely operating profile, so under --
- 8 **CHAIR:** They need two hours or whatever, so the generator X that's offered in
9 at price Y will actually come on, is that the point you're making?
- 10 **MR MURRAY:** They want some time to plan a system to make sure they have
11 transmission capacity available and so forth. Under a different rule,
12 such as at one stage was in the design promulgated which was at that time
13 the UK rule, in the UK they argued that they needed 11 hours advance.
14 What those rules do is constrain what the parties can do because of
15 system security, within that system security they allow the free
16 interaction of demand and supply given that constraint. So, changing the
17 two hour rule changes the constraint that's imposed not for a pricing
18 purpose but allows the free interaction of demand and supply.
- 19 **MS REBSTOCK:** It doesn't really, does it really matter for what purpose it is?
20 I mean the Act clearly envisages that if you breach section 30, if you
21 are deemed to have breached it because of price fixing provisions, you
22 nevertheless can have it authorised because there are benefits from
23 allowing it which may very well be the case where you're doing - setting
24 rules in such a way to deal with security of supply issues. But that
25 doesn't change the first question which is, is it a - caught by section
26 30 or not?
- 27 **MR KOS:** It's not a simple thing like looking at this pen, saying as a matter
28 of philosophical evaluation, it's yellow.
- 29 **MS REBSTOCK:** No, that's why I asked you at what point how much does it have to
30 be constrained before its caught.
- 31 **MR KOS:** The question I think was more in relation to whether section 30 and
32 its purpose is relevant. When you look at the expression "fix", "control
33 and maintain", they are norm tiff expressions in the sense that they, as
34 the Commission has said in the Insurance Council decision, involve a
35 comparison for interference and on the other hand the free fixing of
36 price. The concept of interference must involve some degree, either of a
37 clear purpose or an effect. But in this case the proposition we're
38 making is the price here has to be set in the context of rules because of
39 the nature of the commodity, keep saying that, it must be true, I mean it
40 must be true if I, for instance, agree to sell you this yellow pen that
41 there are some rules that will relate to the trade.
- 42 **MS REBSTOCK:** I don't see the significance in that because it may be necessary,
43 but it still may be caught by section 30 and you still may need an
44 authorisation for it. So, whether it's necessary or not because of the
45 nature of the good or service of the market doesn't seem to be the
46 relevant consideration.
- 47 **MR KOS:** That then takes you back to considering what Parliament's intent would
48 have been and it seems highly improbable with respect that Parliament's
49 intention would have been so all encompassing under section 30 to have
50 caught the range of external transactions we've talked about, besides
51 just this one.
- 52 **MS REBSTOCK:** I think it might help we focus on the transactions we're looking
53 at in terms of jurisdiction of this application. It doesn't help if we
54 say whether it catches everything that moves, we have to focus on these
55 specifics things.
- 56 **MR PALMER:** With respect, to discover Parliament's intention, it's important to
57 look beyond this application, because it may not seem unreasonable that
58 this applicant spends the money on the authorisation application, that
59 there's a lot of consideration given to it. But if three computer
60 companies are tendering for a contract to supply computer equipment to a

1 telecommunications company, there could well be a four-way agreement or
2 understanding. The rules of that tender process will affect the final
3 price, plus or minus a de minimus amount, it's discovering a market
4 price.

5 **MS BATES:** That's a flawed analogy, with respect, because a tenderer isn't a
6 competitor.

7 **MR PALMER:** If those three companies are tendering --

8 **MS BATES:** Yes, but they're tendering in accordance with rules set by the
9 tenderer.

10 **MR PALMER:** If IBM, Compaq and Hewlett Packard are each three tenderers they're
11 competition with one other for --

12 **MS BATES:** Yes, but they're not in competition with a tenderer.

13 **MR PALMER:** They don't have to be.

14 **MS BATES:** The point is with the market all the players are in competition.

15 **MR PALMER:** Yes.

16 **MS BATES:** I see that as a distinction between that and a tendering situation.

17 **MR TAYLOR:** Perhaps the better analogy just taking that point James is that if
18 you had IBM, Compaq and Microsoft together agreeing the rules of a tender
19 process and agreeing between them who should win the tender, that's the
20 analogy rather than where you have a purchaser of the services who sets
21 the tender rules and says these are the tender rules, you're open to
22 tender if you wish to, but the purchaser will make the selection, the
23 purchaser will actually calculate the price dependent on the rules that
24 the purchaser has actually set. So, I can't quite see the tendering
25 process is in any way analogous to competitors getting together to agree
26 rules as to how prices for their goods will actually be set.

27 **MR PALMER:** Sorry I didn't put that well, I could put it better. There are a
28 number of responses to that. The first is that in fact if you ended up
29 with the same contract through either process then you've got the same
30 contract, section 30 is just an effect test. Secondly, the more
31 fundamental point is that if the three companies or all the computer
32 companies get together, the bit that lessons competition is the fact that
33 they're refusing to contract on any other basis, it's that understanding
34 which is the offensive part of the arrangement.

35 **MR TAYLOR:** Just on that last point. The offensive part of the arrangement
36 would not be getting together on the non-price activities as such, is
37 that if they get together and formulate a set of rules that results in
38 the price at the end of the day they've agreed a process, or they've
39 agreed a methodology by which the price will be arrived at, and you talk
40 about the price fixing arrangement and refer back to the Insurance
41 Council issue, that does overlook of course that section 30 is also
42 directed at arrangements which provide a methodology or a process or a
43 basis upon which price can be determined.

44 The individual competitors don't have to have final control over
45 the price, provided they get together and agree the methodology, then
46 that falls within section 30. I think we just need to again put into the
47 overall perspective of this, as a point of principles we can see that
48 there will be various arrangements which will have necessity or
49 efficiency enhancing benefits and in fact your reference to Professor
50 Koss says that in order to get perfect competition you need a set of
51 rules but that depends on the set of rules that you're actually looking
52 at.

53 One of the purposes of the authorisation process is to give the
54 Commission the opportunity to examine the rules, which fall within
55 section 30 to see whether they are getting near to perfect competition,
56 provide a lot of benefit, and therefore ought to be authorised. Isn't
57 that really how Professor Koss' concerns, his argument is dealt with
58 underneath the Commerce Act?

59 **MR KOS:** I don't think Professor Koss anticipated though that perfect
60 competition would constantly go through a process review here. Isn't

1 that the difficulty with the proposition? I'm not sure how much further
2 - we can simply take the proposition that the nature of the commodity
3 necessarily requires rules both as to physical trade and also the setting
4 of price, because it is inherent in the commodity there is no
5 interference with the finding of price by having rules.

6 **CHAIR:** I think you've made the point I think. Kieran Murray provided an
7 illustration, basically the two hour time block between bidding and
8 actual, the price test, the same for two hours. I think that at least
9 puts very squarely where you're coming from. So, we might move on. If
10 we could move it on Dick, by all means.

11 **MR ADAMS:** Sorry, could I ask one question about the price. You have said the
12 set of rules that they operate under will have some effect, although
13 possibly de minimus effect on price at each half hour. If it's a true
14 price discovery process, market is working properly, would prices vary
15 significantly over a longer period? In other words, would the prices
16 balance out over a relatively short period of time or would you get a
17 consistently higher price using one set of rules than you would in
18 another?

19 **MR PALMER:** In terms of whether or not an arrangement with those characteristics
20 would breach section 30 if it's just de minimus and unbiased variation
21 then it should balance out.

22 **MR ADAMS:** Not necessarily in relation to section 30 but just in general, would
23 you get a different price over a slightly longer period of time than half
24 an hour, under a different set of rules that could replace the set of
25 rules that we're proposing here.

26 **MR PALMER:** There should only be de minimus differences. Economists are fond of
27 drawing supply and demand curves that crisply intersect and you can draw
28 across to the horizontal axis and you get a crisp price. In fact you
29 don't bump into supply and demand curves when you're walking down the
30 street, they're formed by rules and markets. Fundamentally the law of
31 contract is a set of rules which constrain behaviour and pricing. If we
32 had a slightly different law of contract we'd have slightly different
33 prices, perhaps. In the same way exchanges could have slightly different
34 rules, but as long as they don't create structural impediments to price
35 finding, as long as they don't bias prices, those de minimus variations
36 between different acceptable market arrangements just exist.

37 **CHAIR:** We have to make a judgment given the illustration that Kieran showed
38 with you bid in, the price remains for two hours, contrasting with bid
39 in, the price remains for 11 hours, as an example of what the particular
40 set of rules can do to price discovery.

41 **MR MURRAY:** What those particular rules did was say that generators couldn't
42 alter their offers without good reason within that time period. It
43 didn't mean that the price would stay stable during that period, because
44 other things could change, and the question of a time profile, the answer
45 that James was giving, was all other things being equal, if some other
46 factor changed during that period, it would expect a change in price.
47 But that's not a function of the change in the rule.

48 **CHAIR:** Can we move on?

49 **MR TAYLOR:** I just need to cover off transmission pricing and cost allocation
50 procedures. I think it's pretty well understood that transmission costs
51 are an inherent part of the costs of electricity at the end of the day
52 and I am interested to hear your comments in relation to the Commission's
53 case of Caltex New Zealand and the car wash case, where if there was an
54 agreement between competitors over an aspect of a particular cost which
55 was an integral part of the price of the end product, but that amounted
56 to a price fixing arrangement under section 30, how does the arrangement
57 between the competitors here in relation to transmission pricing, albeit
58 it's agreeing a methodology which later of itself will derive a
59 particular price charged to those competitors, how does that relate to
60 the court's findings in Caltex and the car wash case, in relation to the

1 car wash discount arrangement.

2 **MR PALMER:** Could we just have a minute now to --

3 **MR KOS:** I wonder if that - the alternative is we can come back, not waste the
4 minute now talking about it, come back --

5 **MS BATES:** I think it's probably good idea to complete it in sequence actually.

6 **MR TAYLOR:** Just while you're considering it, the similar question obviously
7 arises in relation to the cost allocation procedures. (Pause for
8 Discussion).

9 **MR KOS:** It's a complicated question, complicated context, but we'll have a go.

10 **MS BATES:** Come back if you want to rethink it and add to it later.

11 **MR KOS:** Sure.

12 **MR PALMER:** In Caltex what seemed to be objectionable and why it was an
13 interference with normal supply and demand is that competitors were
14 getting together and agreeing not to offer free car washes, which was in
15 a sense agreeing not to give a freebie is the same thing as agreeing not
16 to give a discount, so that was an interference with normal market
17 practices where each company would decide for itself what to offer. Here
18 there's a product transmission or a service. The system operator
19 services under the rulebook, which is being acquired for perfectly
20 sensible, efficient reasons in a sense jointly.

21 Transmission services are shared, they benefit multiple parties, in
22 some way the costs have to be divvied up between them. As long as that
23 cost decision isn't copped by some kind of understanding, as to how it
24 will be passed on to the purchasers, it's our submission that there's no
25 interference with supply and demand and the Insurance Council case is
26 useful in that context at paragraph 36 after it set out the test it goes
27 on to talk about when something like a knock for knock policy might be
28 offensive and he uses the example if it's accompanied by an understanding
29 that the discount or the resulting cost save something not passed on to
30 consumers, but if it's just a sharing of costs, if it's two take-away
31 stores sharing a delivery van that could have some, that's a cost which
32 those businesses will take into account in their pricing, but it's our
33 submission that it can't possibly have been Parliament's intention that
34 that kind of arrangement, which has no discernible impact on the ultimate
35 cost of take-away food delivered, in the sense that's freely set by
36 supply and demand, cannot have been Parliament's intention to make that
37 kind of conduct unlawful per se.

38 In favour of the narrow reading of section 30, I just make the
39 submission that if conduct is found not to be in breach of section 30
40 because it's given a narrow interpretation, section 27 is still there, so
41 if an arrangement does list in competition then section 27 is still there
42 to catch it. Whereas a broad interpretation of section 30 per se,
43 illegal, only way the conduct which will often be good conduct in the
44 example of the two take-away companies is for going to the Commission for
45 an authorisation.

46 **MR TAYLOR:** I hear what you're saying on that James. I think there's a number
47 of issues that still arise in relation to the commentary in Caltex in
48 relation to whether something is of a continuing permanent impact on
49 price. I think you've used the phrase where there's no discernible
50 impact on price, something can't be caught by section 30. But if it is
51 something that has a continuing and permanent effect on price, then
52 presumably that could be caught by section 30 in principle.

53 **MR PALMER:** That's not our submission. That's a distinction essentially from
54 MACQS. We have two submissions, our primary submission is that the MACQS
55 submission is wrong to draw that distinction. For example, it would mean
56 cost sharing between a vertically integrated telecommunications company
57 which provides access to part of its infrastructure, at a cost which is a
58 substantial component of the competitors final cost for its services
59 would be caught and would be per se unlawful under section 30.

60 For that reason that distinction is submitted as incorrect. A

- 1 secondary submission is if you apply that distinction we're in the no
2 discernible effect on the prices range of it, and the example of that is
3 that the value of traded electricity is about \$2b, the value of ancillary
4 services which is one of the shared costs is about \$20m so it's in the
5 "no effect" category.
- 6 **MR TAYLOR:** Just one further point in relation to this. Raised in the
7 submission that if the Commission did find that these sharing
8 arrangements or the involvement of transmission pricing methodology and
9 cost allocation procedures were in breach of section 30, that we should
10 rely on the exception in section 33 of joint buying and when you were
11 describing the position in relation to the cost sharing you said that in
12 a sense these are joint. I just wanted to see how that comment had any
13 impact on the submission that we should treat these issues as being
14 exempt under section 33.
- 15 **MR PALMER:** It's our submission, it is in fact a joint acquisition. I qualified
16 it by in a sense knowing in the draft determination the Commission had
17 rejected that view.
- 18 **MS BATES:** Can I just ask a follow-up question, I just want to clarify it for
19 myself. The spot market as you say necessary, it's a necessary way to
20 trade electricity. Now, is that --
- 21 **MR CAYGILL:** In the absence of vertical integration.
- 22 **MS BATES:** How do non-members get on then, how do they trade?
- 23 **MR MURRAY:** Currently there's an arrangement with the MARIA agreement, the party
24 again to a multi-lateral agreement that has within it a trading mechanism
25 whereby their unders and overs are brought and sold to NZEM.
- 26 **CHAIR:** That's in addition to a contract.
- 27 **MR MURRAY:** MARIA forms a contract so they join a contract called the MARIA
28 agreement.
- 29 **CHAIR:** Yeah but if you say it's unders and overs, if you're trading say with
30 generator A then the residual amount can go back to the spot party.
- 31 **MR MURRAY:** The MARIA agreement has what's called a load-following generator
32 concept. What that means is that on that bilateral trade they have an
33 under or an over and it's deemed to have been brought or sold to NZEM.
- 34 **MR PALMER:** Peter just to finish addressing your point on section 33 before we
35 move on, it certainly is our submission that the services which are
36 acquired by members under the rulebook, so the system operator services,
37 also ancillary service provision, also transmission services which,
38 although not directly acquired under the rulebook, the price is partly
39 determined under the rulebook, are acquired collectively as well and
40 certainly it's our submission that section 33 applies on its face.
- 41 **MS BATES:** Costs aren't jointly acquired are they?
- 42 **MR PALMER:** No, but the services which you pay for are jointly acquired the
43 costs go to admission of the rulebook the system operator, the clearing
44 manager, the roll of the pricing manager, that's something - that's a
45 service which is for the participants in the market which they need
46 performed and which they jointly acquire.
- 47 **MS BATES:** Could I just take a minute. What's occurring to me, they don't get
48 together and buy a service, do they ?
- 49 **MR KOS:** Yep that's the rulebook.
- 50 **MS BATES:** They buy a service, they don't just set a common cost for the
51 service.
- 52 **MR PALMER:** They purchase common quality, they purchase the system operator
53 services through the agency of the electricity governance board, but
54 they're all collectively acquired. It's not, they're not determining in
55 here the price that they will go out and acquire something from somewhere
56 else, it's through the rulebook.
- 57 **MS BATES:** But jointly acquired, jointly acquired.
- 58 **MR PALMER:** The pricing manager services aren't in part acquired by one partner
59 in part acquired by another, there's just the pricing manager's services
60 which they collectively acquire.

- 1 **MR KOS:** And which the rulebook then provides for the allocation of amongst
2 them.
- 3 **MS BATES:** Thank you.
- 4 **MR TAYLOR:** Just one point just to follow-up on the joint acquisition. Joint
5 acquisition of some quality services, services which are required jointly
6 through the rulebook such as the pricing manager services etc, how does
7 that relate to transmission services, are transmission services jointly
8 acquired or individually acquired?
- 9 **MR CAYGILL:** If part F is being used then it's joint, that's the whole point of
10 using part F. If you could reach a contract with Transpower in relation
11 to transmission investment you're absolutely free to do it, go ahead any
12 time. You come to the processes in the rulebook if it is convenient to
13 use those processes, for example, because some will benefit but are not
14 sufficiently persuaded that they should pay, and therefore you use the
15 part F processes to create the coalition, and the binding arrangement, in
16 relation to obligations to pay, that can then be offered to Transpower to
17 perform a contract. They're inherently, I can't think of why somebody
18 would use the part F provisions who was prepared to, and interested in,
19 negotiating bilaterally with Transpower, they'd just go ahead and do
20 that.
- 21 **CHAIR:** We'll take account of that and obviously make a judgment on the three
22 elements which the draft determination differs from your views. Just
23 before moving forward further I see the next thing on your list is the
24 guiding principles. One of the members at least would just like to go
25 back to the scope of any authorisation. You will recall that when we
26 were looking at clarification we came back I think and stated what the
27 authorisation actually covered. So, you might pick that up Paula.
- 28 **MS REBSTOCK:** I'm not sure if you intended to come back to the issue of scope of
29 the authorisation.
- 30 **MR PALMER:** It is one of our later topics but we're happy to address it now if
31 that suits the Commission.
- 32 **CHAIR:** I think we'll pick it up in your order might be the best thing. Let's
33 get on to number 3 which I think is the guiding principles.
- 34 **MR KOS:** Mr Chairman, members of the Commission, this aspect can be dealt with
35 from our perspective anyway in quite short compass. The Commission as we
36 note at point 3.2 in the draft determination, noted a potential for
37 divergence between the rulebook guiding principles and the Government
38 policy statement, and consider those could potentially lessen competition
39 or otherwise harm consumer welfare compared to the counterfactual. We
40 have submitted that in fact those guiding principles effectively
41 implement the GPS and that secondly, they are likely to give rise to
42 benefits for the proposed arrangement in comparison to the
43 counterfactual. We set out in 3.7 briefly why we say that. It's really
44 in seven points.
- 45 The first is at A, page 15, we note that the GPS and the rulebook
46 guiding principles are not the same but that's not the issue. The issue
47 is whether there would be a material divergence between the proposed
48 arrangements rulebook guiding principles and a Crown EGB's rulebook
49 guiding principles, and secondly whether that divergence represents a net
50 public benefit or detriment. That's the first point.
- 51 The second point is found at C2 and 3. The draft determination
52 noted that a Crown EGB guiding principles would be based on the
53 principles and objectives of the GPS, but we submit so too are the
54 guiding principles in this proposed arrangement. Indeed there's no
55 choice, they must be based upon it, because the GPS requires consistency
56 and we make the point in C1, that's consistency that's the expression not
57 slavish imitation.
- 58 The third point is at E. The GPS uses the expression guiding
59 principles or expresses its guiding principles in a different way.
60 They're not expressed as rules or contractual obligations, but they're

1 expressed as objectives or outcomes, they cannot be translated from the
2 latter to the former without modification which is why the applicant and
3 its committees within that applicant organisation have engaged in that
4 modification.

5 The fourth point is at F, and we raise a question, we say, cannot
6 then be said that there will be material divergence between the proposed
7 arrangements rulebook guiding principles and the Crown EGB's and we offer
8 you an answer at 5, the fifth point at G, which we submit that it
9 cannot. We make the submission that a Crown EGB would recognise exactly
10 the same sorts of practical issues that resulted in the development of
11 the rulebook guiding principles by the applicant and by its governance
12 working group.

13 We, at H, make the sixth point. We note that the approach taken by
14 the applicant is consistent with the Act and the processes there,
15 including under that Act the setting of objectives for an EGO which the
16 industry EGB would be through the GPS and also the other six part process
17 of review and oversight that's provided for in sub-part 2.

18 We've noted the GPS which sets the Government's objectives and
19 outcomes. It's then we submit for the EGB to develop rules that achieve
20 those outcomes and objectives but we note that the EGB has latitude as to
21 the means of expression and delivery of those outcomes through its rules.
22 We also make the point that there is no evidence whatever, the Government
23 regards these applicant's guiding principles as an appropriate means of
24 delivery of the GPS.

25 Indeed, in a sense quite the contrary, because the evidence in fact
26 is of extensive consultation with Government officials from the Ministry
27 on the subject, and David can speak to that. So, in essence we submit
28 finally that there is no material divergence between the guiding
29 principles of the proposed arrangement and a Crown EGB. They're likely
30 to be substantially similar, both evolving from existing guiding
31 principles. We submit there isn't any encouragement under these guiding
32 principles for divergence from the achievement of the GPS, and indeed
33 ultimately we submit that you cannot discern a detrimental effect on
34 competition from the preference of the industry model over a Crown EGB.
35 That's really the essence, the essential argument is one of essential
36 conformity between the proposed arrangement and what will be the outcome
37 under the counterfactual.

38 **CHAIR:** Thank you. Just to start off the questioning I guess, as I understand
39 your submission, the basis is that it really is the outcomes rather than
40 specifics, that the guiding principles are concerned about, and therefore
41 the GPS should not really lay down prescriptively how you'd get those
42 outcomes, that's the nub of it.

43 **MR KOS:** Yes, the rulebook and indeed of course the preceding codes, the idea
44 of guiding principles is something which the industry's very familiar
45 from, they are to be found in the proceeding codes NZEM and MARIA and
46 MACQS.

47 **CHAIR:** Probably from earlier Government policy statements I would think but
48 I'm not sure of those. So your main point is it's the outcome that's of
49 concern not the way in which the outcome is achieved.

50 **MR KOS:** Yes, and it actually lays down process of reviewing whether there's
51 been achievement of those outcomes, it's for the EGB to establish its
52 method of delivery.

53 **CHAIR:** Then the auditor general will make a judgment as to whether you've
54 done it or not. The second point, some of the submissions you instance
55 tend to take a different view of course and say that it is the
56 prescriptive application of the GPS is what matters. Have you got a
57 comment on that?

58 **MR CAYGILL:** Yes, A) this is not a new issue. It's one that we have debated
59 often and sought to address. B) the problem I think that that approach
60 raises is what exactly is it that is being suggested? The objection I

1 understand, but what's its implication? What would those of you say we
2 haven't sufficiently conformed with the Government policy statement, what
3 are they actually inviting us to do?

4 The problem being, as Stephen said, the way in which the Government
5 policy statement is expressed, what it calls 'guiding principles' are in
6 fact a set of objectives and outcomes. There's nothing wrong with that,
7 but that's what they are and being that, it's not possible to simply take
8 them up and drop them into a contract and use them in the way that the
9 equivalent section that, which are principles as it were of
10 interpretation, allows.

11 So, going back to your earlier point which I absolutely agree,
12 since the Government has chosen in its policy statement to describe, to
13 set objectives and outcomes without prescribing precisely how many of
14 them are to be met, it seems that actually those who say we haven't used
15 this slavishly enough, are speaking as though there were a level of
16 detail in the policy statement which is in fact not present. There's one
17 exception. In relation to, I believe, in relation to the transmission
18 pricing methodology, the annex to the policy, that is very prescriptive
19 and we have paid very close attention to following that detail, because
20 it is available, in the way in which part F of the rulebook relating to
21 transmission has been designed. But, so where the details were present
22 we've followed it, where the detail's not present and we merely have a
23 set of outcomes and objectives we've said okay that's fine we'll have a
24 set of what are genuinely guiding principles that will enable us to
25 achieve outcomes such as these at the present, or any other outcomes
26 which might be advanced by the Government from time-to-time. I think
27 there's the - if there's a problem at all it arises simply because the
28 same phrase "guiding principles" has been used in two different ways by
29 the industry as a matter of practice and by the Government in its policy
30 statement to describe something which are actually not principles as such
31 at all, but outcomes.

32 **CHAIR:** We'll hear too from the other submitters as to their views obviously
33 but your position, as I see it, is it's outcomes you're concerned about
34 basically and that is the way you phrase the principles.

35 **MR CAYGILL:** Our position is we've taken the Government policy statement very
36 seriously, we have no problem with it, no desire to skirt around it and
37 apply only bits we can get away with. We have sought to implement it as
38 far as our design has gone thus far faithfully and perhaps one other
39 point, have also sought to make sure we're not simply wasting our time
40 here, that in other words we're doing what we hope we can get away with,
41 but actually that's not going to work. So, we've gone back to the
42 Minister directly on more than one occasion and also officials and said
43 here's the language, this is a very important section. I mentioned the
44 two consultation rounds. People commented on the guiding principles
45 section of the draft rulebook in both of those consultation rounds,
46 changes were suggested. We debated whether they were changes we should
47 take up, we made amendments I think in both instances.

48 Having changed something that seemed to be really fundamental to
49 the agreement we then went back, made sure that the Minister had the
50 opportunity to say no, I'm not happy with that. All I can say is we've
51 had no signal at all that, as this section of the rulebook stands, the
52 Government sees any problem with the language we have chosen to put in
53 the rulebook.

54 **CHAIR:** Just of course the Commission isn't aware of what the Minister said,
55 that's not our role. So we do need to see how this squares up with the
56 submissions made by people who want further changes to the guiding
57 principles. That was point one. The second point similarly we haven't
58 talked to officials about their ongoing dialogue.

59 **MR CAYGILL:** I'm not suggesting that in itself constitutes some test of which
60 the Commission should take cognisance. I think the point might be put

1 this way. Those who want changes need to demonstrate they are
2 appropriate, referable to some counterfactual. Without going back over
3 the question of what's the appropriate counterfactual we talked about
4 earlier, in this area I think it's reasonable to assume that the
5 Government, having issued a policy statement, this policy statement would
6 apply to any Crown EGB as well. So, the only issue now is, have we
7 conformed as far as we can to that. I can describe our process. We've
8 had a number of meetings about that.

9 On the other hand when I look at the submissions of those who say
10 well great a conformity is possible, it bluntly is not clear precisely
11 what is being suggested.

12 **MR KOS:** Can I add to that and say not only is it not clear, but nor am I at
13 all clear why the question is being asked, because the Commission is a
14 kind of mediating role for the improvement of applications and the
15 Commission will never get its work done: Function we're not engaged in
16 here is trying to improve the application, but testing the application
17 against the counterfactual to see whether there is a net public benefit.
18 We must go back to that heart land proposition. Now, here --

19 **MS REBSTOCK:** Do you think the Government policy statement has anything to say
20 about whether the proposal might have net benefits or detriments? Don't
21 you think there's a close correlation between the issues that Government
22 policy statement aims at and what we might look at when we think about
23 net benefits?

24 **MR KOS:** I'm not disagreeing with that. That's not the point I'm making. But
25 I'd start with the legislation. The legislation lays down a framework
26 for testing whether, in either the EGB or Electricity Governance
27 Organisation has met the GPS, and also the performance standards that are
28 negotiated.

29 **MS REBSTOCK:** And you've accepted that the counterfactual is a Crown EGB that
30 will have to follow the GPS.

31 **MR KOS:** Yes.

32 **MS REBSTOCK:** So there must be a very important link here to whether, in terms
33 of comparing your proposal to the counterfactual on whether you have
34 aligned with the GPS, because it will tell you what the points of
35 departure may or may not be and then we'll have to look the relative net
36 benefits of that.

37 **MR KOS:** There's a step in that analysis which has to be tested. The question
38 is how would each of those two models conform.

39 **MS REBSTOCK:** Sure, yes.

40 **MR KOS:** The submission we make is they will conform in the same way for the
41 same practical reason, that the rulebook which the counterfactual would
42 have, would also have to have operable principles.

43 **MS REBSTOCK:** Sure. Leaving aside the fact that we have to define the
44 counterfactual properly, nevertheless you accept that we have to look at
45 the extent of which each one would conform to the GPS, because it's part
46 of the counterfactual and it's part of the provisions under the
47 establishment of an industry EGB, so it's perfect. I heard you asking
48 the question why is the Commission pursuing the question about the
49 alignment with the GPS and is that appropriate, but I - I'm not really
50 sure if that's what you're suggesting to us.

51 **MR KOS:** I'll come back. I think we are in disagreement on that point, because
52 the question of alignment is between the proposal and the counterfactual.

53 **MS REBSTOCK:** Sure.

54 **MR KOS:** And that's the measure.

55 **MS BATES:** Could I follow-up? I just want to go to the Act itself and
56 specifically part 2, because - sub-part 2 and I'm starting at 172.Z.I,
57 because the Minister does have the ability to apply that part of the Act
58 to an industry EGB.

59 **MR CAYGILL:** Yep.

60 **MS BATES:** We don't know, do we, at this point whether the Minister will or will

- 1 not do that?
- 2 **MR CAYGILL:** No we don't. What we know is that that's been the applicant's
3 objective.
- 4 **MS BATES:** To get the Minister to do that.
- 5 **MR CAYGILL:** To produce a set of rules which would sufficiently commend
6 themselves to the industry in the first instance and thereafter the
7 Minister, that that would, that would be recognised in terms of sub-part
8 2, therefore we wouldn't be in a sub-part 1 Crown EGB environment.
- 9 **MS BATES:** If it does that then under 172.K.Z the Minister must set objectives
10 and outcomes that the Government wants.
- 11 **MR CAYGILL:** Yes.
- 12 **MS BATES:** Would it not do that in accordance with the Government policy
13 statement?
- 14 **MR CAYGILL:** No, I think it would do it via another Government policy statement.
15 I don't want to quibble but that's the mechanism it would use, I think --
- 16 **MS BATES:** The heading of that subsection is setting of GPS objectives and
17 outcomes which would tend to indicate it's looking at the Government
18 policy statements when it's looking at its objectives and outcomes.
- 19 **MR CAYGILL:** I'm not sure whether we're talking past each other or I'm
20 misunderstanding your question. I read this piece of legislation as
21 having been written actually in the light of what the Government had
22 already done. It adopted the policy statement mechanism and that
23 mechanism I believe does not predate the current document. There wasn't
24 a mechanism of this kind used --
- 25 **MS BATES:** Policy statements, December 2000.
- 26 **MR CAYGILL:** Yes, that's right. That was written at the same moment as the
27 bill. Parliament enacted the law we're talking about later the following
28 year. So, when --
- 29 **MS BATES:** When you get to subsection 2 of 172.Z.K says the Minister must set
30 those objectives and outcomes by giving the electricity governance
31 organisation a statement of Government policy containing those objectives
32 and outcomes. What I wanted to ask you is, is that likely to happen, do
33 you want it to happen? And will that statement be in accordance with the
34 Government policy statement that we have, or in accordance with your
35 guiding principles or both? Do you see where I'm leading to? Is there
36 going to be something else?
- 37 **MR CAYGILL:** I think I understand the question, and I hope I don't sound
38 argumentative if I answer it in this way.
- 39 **MS BATES:** No, you're allowed to be argumentative.
- 40 **MR CAYGILL:** I try not to be, that's the point I'm really making. I think the
41 present Government policy statement is a good example of the type and
42 style of document contemplated by the Act.
- 43 **MS BATES:** Yes.
- 44 **MR CAYGILL:** Next, I know of no indication, there's not been any during my
45 involvement, along the lines of, and if the Electricity Governance
46 Establishment Board succeeds in having its rules authorised, we will
47 recognise it as an Electricity Governance Organisation and the present
48 GPS will do in terms of 172.Z.K. That last step has never been --
- 49 **MS BATES:** That's what I'm really wanting to ask you about, because it's not
50 clear, that it would just say the guiding principles equals the
51 Government policy statement, there's no evidence to suggest that would be
52 the situation either is there?
- 53 **MR CAYGILL:** Well, no there's not. But I'm sorry I want to clarify the language
54 because now we are, that makes them sound as they they're intended as
55 sub-institutes and they're not. That's not how the applicant views the
56 matter at all.
- 57 **MS BATES:** I'm merely trying to clarify because there is this piece of
58 legislation. You've said you probably want the Government to invoke it.
59 We want to understand how the objectives and outside comes under the
60 Government policy statement squares up with your guiding principles, or

- 1 how it may square up, we think it's a legitimate question to be asking
2 you.
- 3 **MR CAYGILL:** Absolutely. Firstly I can only say that the way we read the Act it
4 would be open for the Government to recognise the industry EGB as an EGO
5 and either apply the pre-existing Government policy statement that we
6 know of now to that - to the EGB formally by using the mechanism there,
7 or to issue a fresh one, if for some reason some --
- 8 **MS BATES:** It has the option. It's a Government policy statement and it can do
9 what it likes.
- 10 **MR CAYGILL:** Exactly. If either event, we can't say whether we would conform -
11 if there were a new GPS, the question's hypothetical you know, hard to
12 say whether we would conform or not.
- 13 **MS BATES:** Especially at this point there may be a new GPS.
- 14 **MR CAYGILL:** Exactly. What we've said is well, the only GPS we know of, the
15 only one we've got that we can steer by is the one that was issued
16 in December 2000 modified slightly in the light of the winter review, but
17 not as regards the guiding principle section. We have sought to conform
18 to that. We believe we do conform to it. The fact that we have chosen
19 to include in our rulebook a section called guiding principles which does
20 not follow closely the language of the piece in the Government policy
21 statement which is headed guiding principles for the electricity
22 industry, simply arises because those two - the phrase guiding principles
23 is now being used in two different ways.
- 24 Our rulebook uses guiding principles to decide a set of principles
25 of interpretation along the lines of the three existing codes all of
26 which contain similar components. However, taking our rulebook as a
27 whole, we believe it conforms to the GPS in that it will provide a means
28 of achieving the various objectives and outcomes which the Government has
29 described as guiding principles in the Government policy statement.
- 30 **MS BATES:** But, I'm not trying to belabour but if the whole thing gets into
31 motion, Government brings down sub-part 2, it's going to give, formally
32 be giving you, or giving the EGB objectives and outcomes in accordance,
33 because it's got a statutory obligation to do so.
- 34 **MR CAYGILL:** Yes.
- 35 **MS BATES:** In that context the GPS takes precedence over guiding principles.
- 36 **MR CAYGILL:** The GPS is a statement of objectives and outcomes, against which we
37 would need to negotiate specific performance targets. Were the existing
38 GPS to be confirmed as the statement of objectives and outcomes against
39 which we needed to negotiate policy targets, I can see no difficulty
40 presented by the language we've put in front you in that regard, and nor
41 am I aware of any difficulty that would exist in that respect in the
42 minds of either the Minister or any of his advisors.
- 43 **CHAIR:** I think that will emerge if the process goes through that practice
44 because against the performance arrangement you negotiate in the context
45 of the GPS then the Act provides for the Auditor General to decide
46 whether it matters or not, that's the process.
- 47 **MS BATES:** I'm exploring this because there are submissions about - we've heard
48 the guiding principles not being on all fours with GPS, I'm just trying
49 to demonstrate, GPS is going to come in in any event I think.
- 50 **MR CAYGILL:** Yes, that's right, I agree. And we've sought to steer by it, there
51 is no difficulty here. Perhaps I can add another point, that we have had
52 some preliminary discussions with the Parliamentary Commissioner for the
53 Environment, I think if I'm not mistaken with the controller and you had
54 auditor general as well. They have no function at this point to give us
55 a preliminary tick-off, but on the other hand nor has anybody wandered
56 along and said well for starters, you're going to have to tighten that
57 bit of your language up. They would have been under no obligation to
58 have the second kind of communication but the fact is they haven't.
59 We've been around a while with this language out there having gone.
- 60 **CHAIR:** But in practice until you, if the thing is authorised by us, is he,

1 it's then voted on etc, then next a performance agreement, so in practice
2 you won't get something out of them until they have something to respond
3 to I think.

4 **MR CAYGILL:** That's entirely fair. A more relevant point then is to simply
5 repeat on the other hand we've talked with Ministers, advisors who - and
6 said well, you know is this - have you got you know can anybody see any
7 problem here and the answer is no and that's a question we've asked on
8 more than one occasion.

9 **CHAIR:** Okay. I hear what you're saying. If advisors were like I used to be
10 they were kicking for the line as well, but that's only feasible.

11 **MR CAYGILL:** Talk to the organ grinder as well.

12 **CHAIR:** I understand what you say.

13 **MS REBSTOCK:** I just wanted to follow-up. You indicated that in the area part F
14 given the policy statement was most detailed and you feel you followed it
15 quite closely, my understanding is Meridian has indicated that they don't
16 think the pricing principles are fully aligned with the GPS, and I wanted
17 to ask you to comment on that, and it's particularly in reference I
18 understand to ensuring that there is stained downward pressure on
19 electricity costs and that competition is promoted and you achieve
20 outcomes that reflect what you might see in a competitive market.

21 **MR CAYGILL:** I think those - part F has been the subject of a lot of work and
22 consultation and it's perhaps not surprising - on the other hand it's
23 new. We're not amending an existing document we're trying to devise out
24 of old cloth here and it's probably not surprising that there is still
25 some degree of anxiety or even disagreement about it. The particular
26 objection as you state it seems to me to be at a rather high level. It's
27 not obvious that the detailed way in which we - it's not immediately
28 obvious that the detailed way in which we formulated an entire chapter of
29 a rulebook bearing in mind that the GPS supplied a detailed formulation
30 itself, the one being - needing to conform to the other, that that
31 process somehow fails to conform to a high level objective like, is this
32 a - do the - does the result maintain a downward pressure on costs.

33 I would respond to the specific point that what part F provides, as
34 the GPS itself did, was a process for allowing the industry to fill a
35 contractual void. At the moment there is no clear process whereby the
36 industry can negotiate with Transpower for additional or different
37 transmission services. People are free to negotiate and if they're
38 prepared to pay themselves, well then there isn't a contractual problem.
39 But if they don't agree with the price that Transpower might be asking,
40 or they can see that others would benefit as well and they're prepared to
41 contribute their share but so long as others come along, in either event,
42 a disagreement about price or a hold out from others who might benefit,
43 there's no mechanism for closing that gap. Part F addresses that.

44 The result of part F is likely to be that it is easier for the
45 industry to influence the level and nature of transmission services. I
46 can't conceive that that being the case there would fail to be downward
47 pressure on transmission costs. I mean surely that's going to be the
48 industry's principal objective in using the provisions of part F. The
49 industry's not going to be interested in seeing transmission costs rise,
50 it's going to be interested in seeing them fall. Part F provides a set
51 of processes that the industry will be able to use to secure contractual
52 commitments in relation to transmission services. It seems to me with
53 respect completely consistent with the objective you spoke of. Now I
54 believe in fact that the fundamental disagreement, if it's fundamental at
55 all, lies around the detail in the mechanism, not actually around whether
56 it meets the objective you spoke of.

57 **MS REBSTOCK:** And the outcomes would mirror those in an competitive market.

58 **MR CAYGILL:** Sorry.

59 **MS REBSTOCK:** The objection of the principles in part F don't align with the GPS
60 with respect to whether the outcomes would mirror those that would apply

1 in a competitive market?

2 **MR MURRAY:** May I add something to that? The appendix to the GPS sets out some
3 specific pricing principles for transmission. Section three of part F
4 has within it a process where the EGB would evaluate pricing
5 methodologies against pricing principles and sets out in that section
6 those principles taken directly from that annex, those transmission
7 pricing principles with the exception of one and that is what the
8 Government has a principle around minimising transmission losses which on
9 the application by, or suggestion by Transpower, was not included because
10 it's in the - a pricing principle but an operating principle, principle
11 relates to or the statement relates to the operating of the grid to
12 minimise losses.

13 As I understand what Meridian's submission, they're saying those
14 principles that were in the GPS related to transmission pricing were not
15 complete and that there should be further principles added to those
16 transmission pricing principles.

17 **MS REBSTOCK:** To cover these two points.

18 **MR MURRAY:** To cover those points he --

19 **MS REBSTOCK:** You mentioned that some of the objections in terms of the
20 application of the GPS and how well, it lies with the guiding principles
21 in the application, it's hard to address because they're at such a high
22 level. I note that Transpower has indicated the high level of the
23 guiding principles themselves make it difficult to apply them as a
24 constraint in the context of any given proposal. In other words, they
25 can mean anything to anyone, it's often an issue with high level
26 principles. I'd just like your comment on that if you would please.

27 **MR CAYGILL:** Well, I would say that, as you've said yourself, that that is to a
28 degree an inherent difficulty in the application of principles. Having
29 said that though, I don't believe the language in this rulebook is any
30 more general or at any higher level than the statements of principles
31 contained in the three multi-lateral agreements at the present time. In
32 other words the industry has been used and its compliance bodies in
33 particular have been used over the last six years to interpret this level
34 of generality and using that as a test of the conformity of rules or
35 proposed rule changes. I can't take - I don't think we've altered the
36 nature of the - of what we're talking about as rulebook principles. The
37 industry is simply rationalising, modernising if you wish, revisiting, a
38 set of statements that it's used to using, checking them against the
39 public statement of the Government, consulting about them, will there be
40 room for argument as to whether principles A through F are all equally
41 met in a particular proposal in future? Yes, I'm sure there will be.
42 But I've seen these kinds of expressions used by us, as an Establishment
43 Committee, testing our own proposals, I've seen them within the context
44 of the grid security used to test proposals for rule changes there. This
45 is a process that does work and is useful and I think if we were to take
46 Transpower's point not so much be looking for different language as
47 looking for a different level of language, either a greater degree of
48 definition, or I'm not sure what else, perhaps that. Then I think you
49 would be moving away from something that was as clear and useful as we've
50 tried to make those statements.

51 **MS REBSTOCK:** Just one last question. One of the generators seems to suggest
52 that wouldn't be desirable to align the guiding principles too closely
53 with the GPS because some of the goals in it wouldn't necessarily enhance
54 competitive outcomes because some of the goals are inherently, it seems
55 to me, seems to be suggesting they're inherently political. Do you have
56 any comments on those views?

57 **MR CAYGILL:** I can only say that the Establishment Committee as a whole has not
58 had a problem with the Government policy statement. We haven't tried to
59 avoid implementing bits of it or tried to couch our language in a way
60 that largely gets us there and we hope we don't get caught out by the

1 fact that we're not quite there. An individual submitter may have a
2 different point of view and will need to speak to their own perspective,
3 but the Establishment Committee has tried faithfully to honour the GPS
4 and has gone to the Government and said, have we done that? Not have we
5 done that and please don't notice we've missed something out here, but
6 have we done it.

7 **MR KOS:** I guess the question raises another quite interesting point. It's
8 that if you have too close alignment between your contractual principles
9 and the ministerial statement, what do you do when the ministerial
10 statement changes as it's likely to do. I think Commissioner Bates
11 raised in a sense that point before in your question.

12 **MS BATES:** Yes.

13 **MR KOS:** It might be useful if I just made four very quick points to the
14 Commission in relation to how the scheme works. I've taken the time to
15 have a look at the statute again to see how it operates.

16 **MS BATES:** That would be helpful.

17 **MR KOS:** I think the points are these. Commissioner Bates is quite right to
18 say that the GPS will apply to both models because that's the effect of
19 section 172.Z.K. That's the first point. So, it applies to both models,
20 the GPS. The second point is that the Act applies to both models in
21 relation to the GPS in the same way. That's the effect of section
22 172.Z.I. Because 172.Z.I applies to the Crown EGB, or to an EGO, and
23 we're assuming that if this process goes forward and the industry GPS is
24 established it will be an EGO under 172.Z.I. That's the second point.

25 The third point is that the review process if in the Act is the
26 framework to deliver concordance with the GPS through the agreement of
27 performance standards reflecting that - the GPS. So, that's the
28 assurance mechanism, which achieves fulfillment of the GPS, which is a
29 ministerial instrument in the context of the statute.

30 The fourth point is that there isn't, as far as I can detect and
31 certainly hasn't come out in the course of the debate so far, any reason
32 to believe that there will be a different constitution of the guiding
33 principles under the counterfactual, or that if there was a difference
34 that it would actually make a difference in terms of the net benefit net
35 detriment analysis. Those are the four points I wanted to make.

36 **MS REBSTOCK:** Can I just ask one final question to the chairman, because in a
37 way you're putting forward to us a fairly clear proposition that guiding
38 principles reflect the GPS, they're fairly well aligned, but we could sit
39 here and go through all of the submissions from CC93, Comalco,
40 New Zealand WEA, Sustainable Energy, Transpower, Meridian, Trust Power,
41 they don't seem to think so. I don't mean to sound disingenuous but
42 something here just doesn't match up. You're familiar with this
43 industry. If it is so straight-forward that it lines up so well, why do
44 the industry players, so many of them, not seem to recognise it?

45 **MR CAYGILL:** I think that, you'll have to ask them, no doubt you will.

46 **MS REBSTOCK:** I will ask them but I'm interested in your perception of why this
47 is.

48 **MR CAYGILL:** My perception is that the problem they are facing is not actually a
49 problem of miss alignment at the level of principle, it is a disagreement
50 about elements of substance or detail within the design. There are
51 decisions that have been taken about the nature of the board's powers or
52 the voting, the allocation of voting rules or the structure of the board
53 or and so on, about which there have been disagreements from the outset,
54 they've clearly been options, and those disagreements are seen as
55 indicating a different approach which in turn is described as
56 misalignment with the policy statement.

57 Now, I'm afraid I have - I'm reflecting actually a degree of
58 disquiet or difficulty that you could have seen if you'd been the
59 proverbial fly on the wall at some of our meetings. I have said
60 repeatedly, hang on a moment let's deal with each issue on its merits.

1 If we're talking about the guiding principles, where is the misalignment.
2 Don't tell me you'd like a different set of voting rules, where's the
3 misalignment in relation to the GPS? What is it in the GPS that we are
4 not doing that has not - other than literally picking the guiding
5 principles section up and dropping that language into our contract, and
6 I've explained why we haven't done that, because semantically it doesn't
7 work. It's just not something that makes sense in a contractual
8 framework.

9 Other than doing that, I do not understand what misalignment is
10 being referred to and then when I go to the people who I would regard as
11 the authoritative interpreters of a Government policy statement, I do not
12 get an answer which says "yes, we agree there's a misalignment here, go
13 and do better."

14 **MS REBSTOCK:** Can I just - the reason I ask you the question is it seems to me,
15 and we will certainly ask the other players what the specific reasons
16 were for their views are and we will pursue that. But the reason it
17 seems to me to be material is one of the things that the Commission may
18 give weight to is that the guiding principles themselves may put some
19 constraint on how the governance regime works, and we have to form a view
20 on whether that weight should be placed there or not. Should we give
21 weight to the constraint with the guiding principles might give within
22 the structure?

23 **MR CAYGILL:** Absolutely what they're intended to do, so that would be
24 reasonable, yes.

25 **MS REBSTOCK:** That's what they're intending to do. But what I hear from a long
26 list of organisations that I just read out is that when you actually look
27 at it in each particular circumstance that you mentioned, that they have
28 concerns that they don't provide that constraint. Now, that's why I ask
29 why you thought they had concerns, and your interpretation of what was
30 behind their comments is entirely consistent it seems to me with the
31 notion that they don't think the Commission can put a lot of weight on
32 the constraint provided by those principles. Do you think that's fair to
33 say? That's the issue here and in fact that is the issue for us when we
34 look at the net benefit test, when we look at what the dynamics are of
35 this proposal? If we are of a mind to give some weight to those
36 principles then generally we do look closely at principles like these.

37 **MR CAYGILL:** I don't understand how an arrangement that the guiding principles
38 won't effectively constrain the governance board, perhaps because they
39 conflict, or perhaps because they're written at too high of a level of
40 abstraction. I don't understand how such an argument amounts to an
41 assertion that there is not sufficient conformity between those
42 principles and the Government policy statement. To say that something is
43 ineffective or conflicting or not useful is one thing, but my answer to
44 that is, these principles are very similar to, are written in the same
45 style of language, are intended to have precisely the same effect as the
46 similar segment of the three existing agreements. We've got six years
47 experience in relation to NZEM, five in relation to MARIA, two or so in
48 relation to MACQS, of using similar expressions, effectively. That's not
49 the assertion. Perhaps it's what is meant. It's not what I have
50 understood.

51 The assertion is, there's a lack of conformity. The GPS has not
52 been followed. You should do something else. I say, well, other than
53 changing, not the guiding principles, because that's the debate we're
54 having now. I understand why people would like us to change the voting
55 rules or the powers of the board, or something else. But those are
56 specific issues. I don't understand, I'm not helping you other than to
57 explain, you know, how we've wrestled with this issue. I do not
58 understand how ineffectiveness, or object security, or generality, or
59 conflict of any of those criticisms comes out as failure to conform to
60 the GPS. Those are quite different qualities I think.

1 As to failure to conform, because that's presumably what one might
2 expect from the counterfactual, as well as the specific obligation that
3 we've accepted, to that I won't plead guilty because we've all put the
4 effort in and we've gone through - in the consultation rounds when we've
5 said to people okay, let's - does this language work or not, what would
6 you like, or not? Spent a lot of time, for example talking with
7 Transpower, as much time talking with Transpower as talking with
8 officials. How should we modify this language to make it effective, to
9 make it useful, to make it clear? By all means to conform with the GPS.

10 We're left with, if this - I hope this doesn't sound - we're left
11 with kind of a residual mantra that I cannot put a factual context to.

12 **CHAIR:** I think that gives us some background anyway when we hear the others.
13 You're saying you're somewhat nonplus by the final response.

14 **MR CAYGILL:** If that surprises you, it is not a surprise I must say to other
15 members of the team who have been through this exercise with me.

16 **CHAIR:** I wouldn't observe on that, but I think that gives us a very useful
17 background for the other presentations.

18 **MR MURRAY:** Commissioner Rebstock if the question is what weight should be put
19 on guiding principles in a governance structure as a check on decision-
20 making, then perhaps one of the ways of evaluating that is to look at the
21 experience of NZEM which has had a set of guiding principles and had them
22 acting as a constraint on decision-making very much in the way that is
23 opposed under the new arrangements, in the report that Eric and I
24 prepared and submitted, we looked at, reviewed the experience of NZEM on
25 decision-making, I refer to page 59 of that report, I give some examples
26 of where proposals were rejected because they would breach a guiding
27 principle, or in fact one was struck down by the Market Surveillance
28 Committee on fears, it would be contrary to the guiding principles.

29 So, there is experience to draw from on those guiding principles in
30 practice, acting as a filter and a check on decision-making.

31 **MS REBSTOCK:** The Market Surveillance Committee wasn't going to strike down the
32 provision on a basis of a vote of the industry, did it? The
33 surveillance, Market Surveillance Committee itself struck down the
34 provision, is that right?

35 **MR MURRAY:** Yes, that's right.

36 **MS REBSTOCK:** Wasn't put to a vote of the industry?

37 **MR MURRAY:** No that's right. Other rule changes were stopped at the working
38 group or rule committee level because they were thought to breach the
39 guiding principles.

40 **MS REBSTOCK:** I mean we'll come on to this, but it does, I mean the last remarks
41 that Mr Caygill made just leads me to ask the question, given what you
42 described as the remaining mantra and the fact that positions seem to be
43 well entrenched in some areas, not entrenched but people have strong
44 views, if you read the submissions they're consistently taking - and to
45 some extent they reflect to a large extent they reflect the interest of
46 different players and yet this whole arrangement is based on a voting
47 structure that is just going to continually replicate the dispersed views
48 around the room. Doesn't do anything to unlock it, it just provides an
49 opportunity for it to be replayed over and over again.

50 I wonder as the chairman of this whether that, you know your
51 experience to date with this doesn't give you some concern about the fact
52 that this sort of outcome amongst the different sectors of this industry,
53 this is going to be replayed in every vote that the body has.

54 **MR CAYGILL:** I am - thank you for that question because it might surprise you
55 that I'm much more optimistic than that. That's not my view at all.
56 Firstly I think that we are seeing a degree of what I might call tactical
57 behaviour, people are entitled to try through this process to make what
58 changes they can in the arrangements. I don't believe that will
59 necessarily reflect fully the position that they might subsequently adopt
60 when they face the decision well, okay so that is the way the rulebook's

1 going to be, now do I join or not, do I vote to bring it into force? I
2 think the position in relation - the position now does not necessarily
3 reflect the sober evaluation that people will have to make post any
4 authorisation.

5 Secondly I put weight on the roll that the independent board will
6 be able to play. I see it as a circuit breaker. I see some attitudes
7 within the industry evolving as the rules themselves evolve had we not
8 chosen to adopt a base line approach had we said it may take us a bit
9 longer, but let's try and address a number of outstanding issues that
10 people have thrown up, it might be that we had ultimately achieved a
11 higher level of support, assuming we could find a way through some
12 difficult issues, but at the expense of considerably more time. That was
13 a trade-off that we chose deliberately to make, but I think bought
14 ourselves a degree of opposition as a consequence. That opposition may
15 well change as outstanding issues are addressed.

16 The third reason I think that - the third factor that will be
17 different in future which means we're not simply destined to replay the
18 same cycle of anxieties is the capacity of the Minister to intervene. We
19 have an external reference point. The Minister - the Minister is
20 entitled to say and is likely to say, hang on a moment, I'm tired of
21 hearing this particular issue, let me make a judgment about it. Here is
22 what I want to see happen. Now, are you willing to agree to performance
23 targets that take you to that objective or not? If not that's fine I've
24 got some other remedies that I can employ.

25 So, I can see an ultimate circuit breaker in the shape of the
26 Minister's powers, capacity within an independent board to change the mix
27 within the industry, and in any event an intention to address some issues
28 which may well affect views of industry players.

29 **MS REBSTOCK:** Can I just ask one question. In this process have you seen cases
30 where industry players have put forward proposals that were there for the
31 common good of the industry, but were clearly not in the commercial
32 interests of that business?

33 **MR CAYGILL:** Yes. I've seen a number of occasions when - in fact let me start
34 in a slightly different way just very briefly. I think people have come
35 to the table committed to making judgments in the common good. They've
36 operated within an environment where particular objectives are quite
37 well specified. The industry either, if it wants self governance it has
38 to do it in a particular way, not try to reinvent completely freely.
39 People have, on a number of occasions, simply said well this is what we
40 have to do. I can remember a particular chief executive saying, "I may
41 well get told off when I get back to my firm, but this is the view that I
42 think I must take" and I think that that is not just altruism, I think it
43 reflects cognisance of the framework in which the industry, or with which
44 the industry is being confronted.

45 **CHAIR:** I think I'd better bring this very interesting debate to a close. But
46 I just leave one question you may want to answer or not. I presume most
47 of the submitters, at least from the industry, to this conference, some
48 of whom agree with the applicant whole-heartedly, some who don't, have
49 all contributed to the costs so far. I don't want you to give numbers
50 or anything, but one assumes that even some who disagree have at least
51 paid some share of developing the process.

52 **MR CAYGILL:** I think some explicitly, some simply understand the bill will
53 ultimately come to them.

54 **CHAIR:** There's at least some examples of putting your mouth where your money
55 is or your money where your mouth is. That's the first one. The second
56 one which - so at least they're putting their hands in their pockets or
57 they're likely to. So that to me at least shows some intention of trying
58 to make this work. The second one, you may want to come back to it at
59 the end of our deliberations, whenever that might be. You may want to
60 give a view as you see the balance of opinion after all - as part of your

1 submissions when you sum up. But that's over to you. Certainly the
2 Commission would be interested in it.

3 I think again in my view that was pretty important debate. It's
4 gone on a little but I think we've arranged for tomorrow morning to be
5 available so you don't have to be circumscribed for time. We better
6 break now I guess. I'd like to come back at 10 to 4 at the latest so we
7 can resume.

8 The next one according to my list is differences in quality
9 decision-making, which also promises to be an interesting debate. Thank
10 you.

11 **(Adjournment from 3.40 pm to 3.55 pm)**

12 **CHAIR:** I think we'll start again. I'd like to finish at 5 tonight, but
13 certainly tomorrow we'll be willing to go past 5 if people want to. I
14 think the applicant, we can go till 2.30 tomorrow it's been agreed at
15 least protium, so again if we start to run short we can re-look at it.
16 So, if we aim to finish 5, reasonably close to 5, you won't be here
17 tomorrow we may go past 5.30 then. I think the next item on your list
18 was differences in quality decision-making.

19 **MR. KOS:** Thank you Mr Chairman. This is a , in terms of the net benefit
20 detriment analysis, what might be described as a reasonably large ticket
21 item. The draft determination assessed that the industry EGB would have
22 superior rule and decision-making capabilities and it assessed the net
23 benefit in relation to that, something between \$28m to \$57m. The
24 applicant's experts, Murray and Hansen, have in their report filed in
25 support of the submissions on the draft determination assessed the
26 benefits in somewhat more glowing terms at \$45m to \$90m, so it's in that
27 sort of - in that kind of range, and there are clearly both supporting
28 and opposing submissions on this conclusion.

29 The opponents have suggested that the industry decision process
30 would not have superior rule and decision-making capabilities. The
31 submission that the applicant makes is that the opponents are wrong on
32 that conclusion and that the benefits are greater than identified in the
33 draft determination.

34 I think it might be helpful to go fairly closely through the notes
35 on this one because it's an important issue and not one that can be too
36 condensed. So, at 4.7 we talk first about context and we've looked at
37 the proposed arrangement in the counterfactual and we say that they
38 represent two quite different decision-making models for determining how
39 electricity is traded under what we are advancing, decisions are made by
40 the industry participants directly affected by those decisions within
41 carefully defined constraints and that's primarily, of course, through
42 the voting procedures on rule changes and also of course through the
43 working groups.

44 Under the counterfactual, on the other hand, the ultimate decisions
45 are of the Minister and the Crown EGB deciding the outcomes that they
46 consider desirable.

47 **CHAIR:** If you don't mind answering questions on the way, just on that second
48 point, it was debated at length before so I don't want to reopen that
49 piece, but I think the comment to Mr Caygill when we were looking at the
50 GPS and the degree to which that is applied to either structure. So one
51 would assume, all things being equal, that at least under the GPS, yet to
52 be revised or the current one, the prima facie outcomes would be similar.
53 Are you arguing here once they are worked through by a Government EGB
54 they may then be reprioritised or reaudited? Is that what you're saying?

55 **MR. CAYGILL:** I think the outcomes that the Government seeks from the Crown EGB
56 or seeks from the industry EGB are, as far as I could judge, likely to be
57 similar, identical. But the precise way in which those outcomes are met,
58 the mechanisms as they are translated into rules that are binding in
59 different ways on participants, may well as time goes by, differ and
60 potentially differ significantly.

- 1 **MR KOS:** But in terms, Mr Chairman, of this issue, the primary point is the
2 decision-making mechanism and the benefit or the saving associated with
3 that, in the applicant's mechanism with the industry undertaking the
4 decision-making process we submit that for the reasons we set out, there
5 are significant savings to industry participants.
- 6 **CHAIR:** In the way in which and the quality of decisions, that's what you're
7 saying.
- 8 **MR KOS:** That's right. Clearly while the GPS may have identical outcomes and
9 while the Government may have identical expectations for the two models,
10 the methodology of delivery is the first major point of difference, and
11 the second feature is that of course there are decisions that were made
12 by each body outside the scope of the GPS anyway. The GPS is not --
- 13 **MR CAYGILL:** The full universe of things expected that the - certainly not the
14 full universe of things that the industry EGB may choose at the behest of
15 its members to address.
- 16 **MR KOS:** That leads on really into the points - we've covered really points B
17 and C, but at D we make the submission that as a general rule social
18 welfare's maximised by allowing the owner of the resource to use it as he
19 or she sees fit and to bear the consequences. And we've referred to the
20 Adam Smithian concept, the invisible hand. The notion being the foremost
21 fulfillment of societal good comes as an indirect consequence of market
22 participants pursuing self-interest. In this case, as we've recognised
23 at F, self-interest does not always necessarily equate - there's no
24 novelty in that particular proposition, not always necessarily equate
25 with societal welfare. We've noted instances for instance the potential
26 for collusion or free ride, hold out positions, and so --
- 27 **MS REBSTOCK:** Do you want to perhaps help us by telling us what conditions have
28 to hold for that result to - what market circumstances does that result
29 hold in?
- 30 **MR KOS:** Which one of the submissions?
- 31 **MS REBSTOCK:** The proposition that letting the free hand of the market determine
32 the outcomes results in advancing the most socially optimal result.
- 33 **MR KOS:** Marcus in Scotland in 1766 seemed to work then and it's been held
34 occasionally sense then to still apply.
- 35 **MS REBSTOCK:** There are certain economic conditions that have to hold for that
36 result to come about, would you mind telling us what they are?
- 37 **MR KOS:** I'll ask Dr Hansen or Mr Hansen to address that, they'll be more
38 expert than me.
- 39 **MR MURRAY:** It's whether circumstances in which allowing --
- 40 **MS REBSTOCK:** What are the assumptions that underpin the achievement of that
41 result? If you let people who own - if you let the various firms do
42 what's in their self-interest you get the socially optimal result.
- 43 **MR MURRAY:** The general assumption that underlies that presumption is that where
44 parties hold the rights over resource have the ability to make decisions
45 in relation to the use of that resource, and to acquire the benefits, or
46 wear the costs detriments from those decisions, then when they engage in
47 transactions in relation to those resources, those resources will tend to
48 be acquired over time by parties with superior knowledge in the
49 application of that resource and hence economic growth occurs through
50 that.
- 51 Now those decisions always take place within a framework of rules.
52 Those rules start from social norms, conditions that are set by society,
53 legal rules, as here the Commerce Act and Contractual Rules. What we're
54 seeing here is that there are --
- 55 **MS REBSTOCK:** What I was asking you is what characterises, what characteristics
56 of the market have to exist for that effect to be found?
- 57 **MR MURRAY:** Perhaps to answer that in the negative, the effect may not occur
58 where there is potential for those parties to collude in a way, reaching
59 decisions that would not be in the interests of Adam Smith.
- 60 **MS REBSTOCK:** Is it a case of collusion?

- 1 **MR MURRAY:** No, the second one there are groups where there are potentials such
2 as free riding, hold out and --
- 3 **MS REBSTOCK:** What is the environment for the potential for free riding? What
4 is the characteristics?
- 5 **MR MURRAY:** The characteristics of the market where those sorts of effects are
6 higher than elsewhere, is where there are common resources, high degree
7 of common resources, or which is equivalent limited specification or lack
8 of specification of property rights. Both of these features are proven
9 in the electricity industry.
- 10 **MS REBSTOCK:** What about the degree of competition generally?
- 11 **MR HANSEN:** Well, that was Kieran's comment about monopoly power. Even a
12 monopolist, if it's self-interested, will seek to minimise costs and the
13 main concern for Adam Smith then comes down to the allocational issue of
14 monopoly pricing, and the consequential loss of output below the
15 competitive level.
- 16 **MS REBSTOCK:** Just, I mean happy to discuss these sort of basic models, but what
17 I wanted to know was, is it applicable to the markets that we're looking
18 at? Is this really the starting point which we're looking a?
- 19 **MR MURRAY:** The reason why we believe it is the appropriate market is that what
20 these arrangements primarily do is create a means of governance, and in
21 questions of governance the starting point is the transaction that is
22 being governed, that an efficient form of governance cannot be determined
23 independently of the transaction that is being governed, and the
24 transactions that have been governed in this case is the interaction of
25 owners of various resources in the electricity industry, as to how those
26 resources will be integrated where necessary and the trading of those
27 resources.
- 28 Hence it is the engagement of parties who are transacting their
29 property rights over resources, and the question then comes, in what
30 circumstances or how do you design a governance structure such that those
31 transactions may be constrained where they would otherwise have an
32 incentive to an outcome that may not be in the interest of the Society as
33 a whole. The purpose of the governance structure is to provide order to
34 those transactions.
- 35 **MR HANSEN:** Perhaps I could add to that in terms of the externality question
36 where what that really means is once parties get to a point where they
37 may make a transaction which may be mutually beneficial to them, that
38 they may not be able to do that. One way to think about these
39 arrangements is as participants standing back ex-anti, saying if we don't
40 design some governance structure to manage those types of transactions we
41 won't be able to undertake all potentially efficient trades. So, this
42 arrangement attempts in many different ways to overcome, through ex-anti
43 contracting the externality issues, the free riding that gives rise to,
44 through ex-anti contracting, because they know that's in their self-
45 interest because they can gain through mutual trades, but they need to do
46 that in an ex -anti way.
- 47 **MS REBSTOCK:** Does it have to be mandatory, have universal participation?
- 48 **MR HANSEN:** Not necessarily for externality because the point there is the
49 people in the market are actually losing from the fact that at the time
50 they come to do trades the externality kills the deal. If they can sit
51 back from that and say well if we write an agreement that's on us now,
52 that binds our future actions in some way, if we can do that in a way
53 that solves the externality problem, then when it comes to the point of
54 the transaction we'll be able to carry through that transaction and we'll
55 be better off.
- 56 **MS REBSTOCK:** If you don't have all participants binding themselves, how can you
57 solve the externality problem
- 58 **MR HANSEN:** Sorry
- 59 **MS REBSTOCK:** If you don't have all participants binding themselves, how do you
60 solve the externality problem?

1 **MR HANSEN:** Not all externalities are, as you might call, public goods. Some
2 can be characterised more like club goods, so that those who decide to
3 join the arrangement gain the benefits and those that don't. Some parts
4 of the electricity industry conform to that. Others less so, and some -
5 take transmission as an example, voltage is seen as something that's more
6 of a common or local common issue or regional issue. Frequency on the
7 other hand is something that applies across the whole grid and that's
8 where you get to more the end of the pure public good. Even there, there
9 are issues of connection and so on and admission to the club potentially
10 being used.

11 **MR CAYGILL:** Mr Chairman, might I venture a very brief comment on this issue,
12 because I think it is of almost fundamental importance, the question of
13 whether we're right to start from a base of self-interest and then work
14 out where we have to modify that. What strikes me about the Commission's
15 question is that the fundamental nature of the electricity market has not
16 changed since 1996. There are a number of players, and the ownership
17 structures and what have you, but the fundamental nature of the market is
18 not different now than it was six years ago, when it seemed both lawful
19 and indeed appropriate to organise on a disaggregated basis using a
20 vehicle of private contract whereby the parties presumably acted
21 essentially out of self-interest. The one thing that has changed, many
22 things perhaps have changed to small degrees in six years, but one thing
23 in particular stands out. Whereas six years ago the Government of the
24 day encouraged such a, but somewhat, well, now we have a Government
25 equally encouraging arrangements.

26 In the context of a specific declaration which says as a matter of
27 policy it is appropriate that the industry regulates itself, if it is
28 capable of doing so, willing to do so, within these parameters, sure, but
29 it seems to be that the foundation that actors should be encouraged to
30 act in their self-interest as a sort of core premise here is not strange
31 to this industry, not novel to this application, but actually rooted in a
32 design which at a high level is at least six years old in this country,
33 and if not older in other places.

34 **MS REBSTOCK:** I just put it you to that if this market worked perfectly
35 competitively and could reach socially optimal outcomes without
36 interference we wouldn't all be sitting here today. So, I accept that
37 large parts of it may operate that way. But large parts of it do not.
38 So, I'm just - you know I think when we look at an application like this,
39 frankly we would not even be contemplating it if we were in that world of
40 markets reaching socially optimal outcomes on their own unfettered, even
41 - I mean even if it was simply a matter of developing some rules around
42 it. That's not difficult, except for when there are other market
43 circumstances that exist.

44 I think when we do the competition analysis and when we do a cost
45 benefit, we have to be very clear about the nature of the market that
46 we're looking at when we look at the different provisions, and so that's
47 why I was asking for those points of clarification.

48 **MS BATES:** If I just might follow this up with looking at section 172.N of the
49 Act. It is EGB, but it's principal objective being to, you know to
50 ensure electricity is generated and conveyed to all classes of consumer
51 in an efficient, fair and environmentally sustainable manner. That's a
52 principal objective of an EGB - is that a principal objective of an
53 industry EGB?

54 **MR CAYGILL:** That statement replicates the - the structure of the sentence is
55 different but I think with that exception only, 172.N replicates the
56 first paragraph of the Government policy statement, if we assume that the
57 Government policy statement is applied to the EGO it's been the design
58 principle that we have conformed to then our rulebook seeks to achieve
59 that objective.

60 **MS BATES:** What I've asked you is that objective as stated, the principal

- 1 objective of an industry EGB. I'm not asking you - you can see why I'm
2 asking you that because I wanted to see whether you think that - explain
3 how that fits in with the Adam Smith proposition.
- 4 **MR CAYGILL:** It's not our principal objective as such. It's the Government's
5 objective, perhaps that's the difference. Perhaps that's the significant
6 difference between the two sentences. In the one case it becomes the -
7 by statute it becomes the principal of the EGB in the Government policy
8 statement applicable to the industry governance arrangements. It's the
9 Government's objective to which, through the target mechanism, we have to
10 conform.
- 11 **MS BATES:** Yes, but it's the principal objective of a Crown EGB and what we're
12 looking at here is the difference between what - between what an industry
13 EGB will be and what a Crown EGB will be. That's why I'm asking you,
14 will this objective be the principal objective of an industry EGB?
- 15 **MR MURRAY:** What has occurred with that objective is the rulebook takes that
16 objective and interprets it into a set of guiding principles which can be
17 applied in the development of rules. That objective as it is phrased,
18 doesn't provide a very effective way of discriminating between one rule
19 and another rule to the point that Mr Caygill made earlier, that the
20 guiding principles, the Government's guiding principles fail to be
21 interpreted into the rulebook as the principles to guide, or to judge, or
22 evaluate rule changes, some adjustments had to be made to the language to
23 make those principles more effective as an instrument of determining
24 whether to allow a particular rule change to proceed or not.
- 25 **MS BATES:** But the guiding principles, are they in conformity, you say they
26 are, with the GPS?
- 27 **MR CAYGILL:** Yes.
- 28 **MS BATES:** GPS and the EGB, the Crown EGB are the same principal objective. I
29 think it's a pretty straightforward question. Is the industry EGB going
30 to have that same principal objective?
- 31 **MR CAYGILL:** There isn't a rule that I can say yes, I'm sorry, I should have
32 realised this. Turn to rule 17.3.6. There's the same language, in that
33 sense no.
- 34 **MS BATES:** No, no, I'm not asking you about specifics, all I'm asking you about
35 an ethos really. Because you've put one up which starts at the
36 proposition that self-interested decision-making leads to best decision-
37 making. I'm just trying to see if there's a contrast between the two.
38 That's your starting point, is it different from the Crown EGB starting
39 point?
- 40 **MR CAYGILL:** No, I think the two statements are operationally quite different.
41 One is an objective to which, stated by the Government, to which the
42 industry has to have regard, against which its performance will be
43 judged. The other is a statement of mechanism. A statement which
44 explains the --
- 45 **MS BATES:** How you will achieve the objectives?
- 46 **MR CAYGILL:** Indeed.
- 47 **MS BATES:** So you will achieve the objectives, you are saying you might agree
48 with the principle objective being as stated in the GPS, but you'll
49 achieve that with the starting point of self-interested regulation
50 producing the best result?
- 51 **MR KOS:** Perhaps that seems to be both Parliament's and Government's approach
52 as well in that the same GPS chooses the self regulatory mechanism as the
53 means of delivering them.
- 54 **MS REBSTOCK:** But not at any price?
- 55 **MR KOS:** No, I accept that. The further point to add to David Caygill's
56 observation a moment ago is that ultimately the mechanism or the sanction
57 within the Act is that a double negative audit report from the Auditor
58 General means back to the Crown. So, --
- 59 **MR CAYGILL:** I said --
- 60 **MR KOS:** It kind of computes to the outcome you're talking about.

- 1 **MR CAYGILL:** I said this morning under the arrangements proposed there was a
2 healthy tension between industry self-interest and Government oversight,
3 that the former does not sit on its own, that would indeed produce a
4 different result. But the latter, Government oversight, doesn't occur on
5 its own either, otherwise there's no content to self-regulation.
- 6 **CHAIR:** I think you took us to that pretty well.
- 7 **MS BATES:** I understand that. What you're saying is it's a matter of different
8 processes to achieve the same result.
- 9 **MR CAYGILL:** Yes, but leading to important differences in regards net benefit,
10 which is the point that we are seeking to make.
- 11 **MS BATES:** So how are these various different organisations going about their
12 decision-making and your starting point is self-interested decision-
13 making leads to best result. You think self-interested decision-making
14 has a better process do you?
- 15 **MR CAYGILL:** I think it's the right premise to start with in an industry that is
16 addressing large values. James' reference earlier today to \$2b worth of
17 energy being traded in the course of a year with similar values of
18 investment lying behind that in order to produce that quantity, if this
19 were to become an industry where all that matter was the public policy
20 objectives, and the decision-making process is somehow not terribly
21 important, then I think one could rapidly, not that anybody's contending
22 for that, but we're saying there is a qualitative difference which goes
23 to net benefit as between different decision-making processes. It seems
24 to me not hard to see how that could be the case, when you start to think
25 of the value involved in the investment required in an industry which
26 each year produces this volume of goods and services. If people don't
27 have some regard to commercial interests, rates of return, operation and
28 efficient means of proceeding and so forth.
- 29 **MS BATES:** Of course, that goes without saying. I don't see why you wouldn't
30 get that in a Crown EGB, if you have the same sort of line up of board
31 members?
- 32 **MR CAYGILL:** Because the decision-making - let's come to that. The quality of
33 the board is important, but by no means the most significant issue as
34 between the two sets of processes. Indeed I'm not sure that the
35 composition of the board actually goes to the decision-making processes.
- 36 **CHAIR:** I think as you go through the rest of the presentation perhaps the
37 comments from Ms Bates ought to be taken up with it. I think there's a
38 very good point there. Where does self-interest in essence contribute to
39 public good. I think you make it there in what you are saying so I think
40 you should presume.
- 41 **MR PALMER:** To tick off a point which is in Commissioner Bates' mind before
42 moving on though. The second paragraph to the foreword of the rulebook
43 states that:
44 "the rules have been prepared for the purpose of governing the
45 arrangements between members to promote the satisfaction of consumers'
46 electricity requirements in a matter that is of least cost to the economy
47 as a whole and that is consistent with sustainable development."
- 48 **CHAIR:** Thank you.
- 49 **MR KOS:** Two points I think follow and lead this discussion to its next stage.
50 The first one relates to Commissioner Bates' last comment relating to the
51 commonality of potentially personnel on the two boards.
52 The boards have fundamentally different functions between the two
53 models. In the case of the industry EGB, its primary function has been
54 described as more orientated towards the management of process and it
55 also clearly has an important role in terms of policy. But in terms of
56 ultimate decision-making, the board's role is far more limited. We see
57 this when we look at the two process diagrams that appear on page 19 and
58 20 of the notes which have over the last few days become known as the
59 onions. May as well continue that terminology.
- 60 **MS REBSTOCK:** They're going to make us cry.

1 **MS BATES:** Not if you peel them from the right end.

2 **MR KOS:** I do sincerely hope so.

3 **MR CAYGILL:** Use cold water.

4 **CHAIR:** I don't want to get into a side track at all, but I think as was said
5 earlier, one needs to see just if the Crown EGB was set up, just in
6 practice how it would work. One could envisage one model where the
7 chairman or chief executive got a brief from the Minister and off they
8 went. I won't get into that in any great detail. Your point being
9 thought that the proposition for rule changes and the involvement of the
10 Minister is quite direct, as against the industry EGB.

11 **MR KOS:** I'm grateful for both elements of that observation because the
12 comparison between the two models is the point I keep coming back to is
13 opposed to the question of the improvement of the application. That
14 theme I'm sure I've made clear. The second one is Mr Chairman as you
15 picked up the cleft in the Crown EGB onion is indicative of exactly that
16 potentiality.

17 The other thing that you see from it is a series of steps in the
18 decision-making process in the second, the Crown EGB onion which are not
19 mandatory. Whereas if you look at the first on page 19, the industry
20 one, you have a core running down from the top down to the participants
21 voting which represents the rulebook. So the core of that decision-
22 making process is found in the rulebook. Then on the outside you have
23 by-in-large a consistent statutory series of outer rings, the Auditor
24 General, Parliamentary Commissioner, Parliamentary review, societal
25 norms.

26 Now, within that industry, the industry EGB model, the inner core,
27 you have the proposition of a rule change, consideration as to whether
28 that change is consistent with the Commerce Act, process of
29 recommendation as to rule changes by a working group. A working group
30 drawn from active industry participants and other sources too. They
31 don't necessarily need to be - currently active, industry participants.
32 But you have that potential, and indeed participation.

33 The EGB considering whether objectives are met and then coming down
34 critically to the point where participants vote to accept or reject
35 changes recommended by the EGB, and this is the point which answers the,
36 or comes to the question being raised. Where in these two models and the
37 differences between the two models do we see the additional value that
38 the applicant contends exists in terms of decision-making?

39 It's really in these inner core rings, the working group and the
40 industry participants voting which are distinct features of the industry
41 EGB. We'll talk in a moment about the extent to which a Crown EGB might
42 have working groups but which benefit in two or three key areas and I'll
43 ask Kieran Murray to comment in a moment, but we can see that those
44 decision makers in the industry working groups and in the industry
45 participants voting in the applicant's model, having access to
46 information, access to information is a first point of differentiation.

47 Secondly, the capability of participants in the working group and
48 in the voting panels to make decisions.

49 Thirdly, the ability of those people to work through and resolve
50 disputes are the three particular qualities where we say you can look at
51 the two different models and see the greater information access, the
52 greater capability to make efficient decisions, the greater ability to
53 resolve disputes being present in the industry model and that is where a
54 significant part, and Kieran can follow this point up, a significant part
55 of the net benefit that we contend for exists between those two models.
56 Is that a good jumping off point?

57 **MR MURRAY:** Yes, it is. It is something I can argue in attempting to evaluate
58 different decision-making processes, which is what the Commission has
59 been asked to do, is that the appropriate measures are now on each leg in
60 that decision - those respective decision processes. What is the

1 information available to the decision-maker, what is the competency of
2 the decision-maker at that point and as Stephen read out, how are
3 conflicting views resolved.

4 When we go through in a detailed comparison of the two decision-
5 making processes and at each stage we argue that the arrangement compares
6 favourably to the counterfactual on that basis and to pick up some
7 examples.

8 Going to the point of most contention, the industry participants
9 make the final decision on a rule change, whether to accept or reject a
10 rule change recommended to it by an independent EGB. A comparison of
11 that decision process with a decision by a Minister of the Crown making
12 the final decision. The information that is most relevant to that
13 decision, whether to accept a rule change which is - primarily these
14 rules are technical, operational rules around how the power system
15 operates - that the parties who are best placed to make a final
16 evaluation of that rule are the parties whose equipment must be operated
17 according to that rule.

18 According that, there would have been a prior decision that any
19 rule on which they're asked to vote, is and does meet the guiding
20 principles. It's not the industry participants who make that decision
21 but an independent EGB. By comparison or analogy, the level of detail of
22 these operating rules that would be asked of the Minister to make its
23 final decisions on, are a degree that ministers did not make when ECNZ
24 was a combined entity or under the old MED days.

25 **MS REBSTOCK:** They did not make them.

26 **MR MURRAY:** Ministers did not make decisions on the operating details of hydro
27 plant.

28 **MS REBSTOCK:** Supposedly they could have.

29 **MR MURRAY:** They could have.

30 **MS REBSTOCK:** And they chose not to. So, why would they under a Crown EGB, just
31 because they have the ability to, would they choose to make the detailed
32 operational rules?

33 **MR MURRAY:** Our contention is that they didn't then, for the same reason that
34 this current Government's concluded that these decisions will be best
35 made by the industry.

36 **MS REBSTOCK:** Sure, and so under a Crown EGB the Minister may, as Ministers have
37 in the past, be perfectly happy to delegate that back to the industry
38 through the Crown EGB. In fact that is the demonstrated behaviour in the
39 past.

40 **MR KOS:** It's not the industry that it gets delegated back to in terms of the
41 Crown EGB approach.

42 **MS REBSTOCK:** It may not be depending on how the Crown EGB works, but we do know
43 from some overseas experience that working parties made up of industry
44 players are used as they are proposed here under the industry EGB. So,
45 we don't know, but there's nothing in past evidence that suggests the
46 Minister will step in to make the detailed operational rules for the
47 electricity industry if I understand you correctly.

48 **MR KOS:** We don't exclude the possibility that working groups would exist under
49 the Crown model, we don't know.

50 **MS REBSTOCK:** Sure I understand that, but do we have any evidence from the past
51 when ministers had the ability to make the decisions, did they choose to
52 do so, the detailed operational decisions?

53 **MR HANSEN:** That was a world of a vertically integrated ECNZ and one would have
54 to look at incentives in that case and particularly as a state owned
55 entity. So, I wouldn't expect to obtain evidence from that situation
56 that was relevant to this case. I think the point that I would make in
57 terms of whether the Minister will make decisions. One under the
58 regulations as I read them, whether they're rules or regulations, the
59 ultimate decision does fall to the Minister and certainly there would be
60 some decisions that are non-controversial and they would be pretty much

1 formality, but all the important decisions of consequence with
2 significant value at stake will be controversial, and so the Minister
3 will be subject to lobbying even if there's a consensus at one working
4 group level, it may not even be consensus.

5 So, I would see the Minister being drawn into these controversial
6 decisions by the fact that he has that decision right allocated to him.

7 **MS REBSTOCK:** Are they controversial decisions because they happen to be the
8 ones where there's a wider public interest because there are competing
9 interests between the different sectors?

10 **MR CAYGILL:** I think there have been instances in the past where ministers have
11 intervened in issues that - I'll give you a different instance, the
12 question of whether the price of electricity in the South Island should
13 be at a margin from the price in the North Island was intensely political
14 and certainly settled by ministers, not by the industry. But I'd like
15 actually to - apart from offering that as an example, I'd like to make a
16 different point. I think two things have happened. The structure of the
17 industry is very different from a time when there was a single integrated
18 department or a single integrated commercial entity. The industry is in
19 one sense both more differentiated and the issues more politicised than
20 was typically the case a decade or more ago.

21 The second point is it seems to me that what is proposed now in a
22 Crown EGB provides a much more explicit responsibility for a Minister to
23 contemplate using, whether a Minister would or would not wish to exercise
24 power, is important, but not the only issue in a framework where the
25 Minister clearly has that capacity.

26 **MS REBSTOCK:** The reason I asked the question Mr Caygill that I did to your
27 colleagues is, it seems to me, we were talking about the detailed
28 operational rules. In the Commission's view the industry participants
29 clearly have an advantage. Some parts have contested that and we will
30 hear their submissions. It seems to me on the detailed operational rules
31 where there isn't a lot of contested views, I don't know what the
32 incentive could possibly be on the Minister to intervene in something
33 like that.

34 If I can just finish and then I'll give you a chance I promise. It
35 does seem to me however where there will be an even model interest taken
36 by a Minister, is where there is a wider public interest and there is not
37 consensus in the industry, and it's going to be a close correlation
38 between those things. The things that are going to be political are the
39 things where there is a wider public interest. The Minister will have an
40 interest whether there's a Crown EGB or an industry EGB, and in fact with
41 a Crown EGB the Minister can always say I've got an independent body here
42 with decision-making power, they're independent from the industry, they
43 can make those decisions.

44 Whereas under the industry EGB it seems to me from what you've said
45 yourself, where there's an issue with industry self-interest that's
46 regulated because of the tension with the Minister who looks after, who
47 has the role in that model of looking after the public interest. In
48 other words, the Minister has no option under the industry EGB process to
49 play that role, to be the one that creates the tension that balances the
50 public interest with the industry interests where a free market approach
51 won't yield the socially optimal outcome. Now, when I hear you present
52 the political influence on the Crown EGB as the root of the detriments on
53 the Crown EGB, but at the same time you rely on the tension brought by
54 the Minister to get the benefits in the industry EGB, I have a little bit
55 of difficulty connecting the two.

56 In both models the Minister plays a certain role, but in the
57 industry EGB he has no-one else he can delegate it to, but he does in the
58 Crown one. He can delegate it to an independent body that has decision-
59 making powers. So, I'd really like to hear how the Minister is the
60 savior when it comes to the industry EGB because he creates this tension

- 1 to look after the public interest, but on the Crown EGB the Minister has
2 a big problem and leads to a lot of the detriment that you see, but it
3 seems to me the roll is exactly the same.
- 4 **MR CAYGILL:** The powers are different, and the processes are different I think
5 is the simple point.
- 6 **MS REBSTOCK:** Sure, but the issues the Minister will have to confront and deal
7 with are very similar and he has no option with the Crown EGB - I mean
8 with the industry EGB but to play that role.
- 9 **MR KOS:** David's right, the processes are immensely different.
- 10 **MS REBSTOCK:** Sure.
- 11 **MR KOS:** I'm glad you qualified your observation about the ministerial
12 detriment being a lot of the detriment. It's a part of the detriment. A
13 part of the detriment comes from the fact that the ultimate decision-
14 making is the Minister under the Crown EGB. He doesn't delegate that the
15 Crown EGB. It is not the role to make decisions specifically. It is to
16 recommend to the Minister the tension that arises between that
17 organisation and the ability of the Minister to confirm or not that which
18 creates in itself an opportunity for lobbying and for barracking the
19 Minister which you can expect will occur. That's only part of the
20 difference.
- 21 The other key part of the difference is that in the industry process the
22 way in which the rule changes work out is from what is a clearly ordained
23 working group process and we can look at that working group and see what
24 it looks like and say that's how it's going to work and these are its
25 virtues and the virtues we've talked about are access to information in
26 particular and the capability to make efficient decisions because these
27 are people who after all are going to pay for the investments that will
28 result, or the costs that result from the rule changes.
- 29 Secondly, at the level of the actual voting on the rule change,
30 which isn't for the EGB to decide, isn't for the Minister to decide, it
31 is for those participants again who are paying for the cost of the rule
32 change and who are given voting rights under the rulebook. Again, the
33 same benefits apply to those. Not present in the other model.
- 34 **MS BATES:** I want to clarify a couple of things because I think I'm getting
35 slightly confused. When you started off you said that the industry EGB
36 was concerned with management process and policy but had limited
37 decision-making.
- 38 **MR KOS:** Yes.
- 39 **MS BATES:** What do you mean by that? Haven't you just said that as far as rule
40 changes are concerned it's the industry E - no it's the participants that
41 make the decisions.
- 42 **MR KOS:** That's the key. If you go back to the onions you'll see quite
43 distinct rings. Working groups, participants and the EGB, the EGB
44 doesn't make decisions.
- 45 **MS BATES:** The participants make on rule changes.
- 46 **MR KOS:** That's right.
- 47 **MS BATES:** Can the Minister actually review those rule changes if the Minister
48 doesn't like them?
- 49 **MR CAYGILL:** No, the Minister may by specifying outcomes or objectives that he
50 or she wishes to see the industry attain, affect the subjects and perhaps
51 ultimately the detail, but there's a tension, I think that is the right
52 word to use, and an indirect relationship but the Minister has no direct
53 capacity to say you can't have half hour pricing, I want five minute
54 pricing or you know whatever.
- 55 **MS BATES:** I suppose the final constraint on that is if too many broad rule
56 changes came through that the Minister didn't like, simply do away with
57 you.
- 58 **MR CAYGILL:** Absolutely, and then that's part of the tension too and then we're
59 into a different model. That's clearly right.
- 60 **MS BATES:** As far as the process for the Crown EGB is concerned and looking at

1 your own, there is a step there which you don't mention and that is the
2 obligation to consult under section 172.Y, because it's at that point in
3 that onion, the Crown EGB onion, that the industry and other interested
4 players get the chance to have input. I'd say that that should be taken
5 into account, the fact that there is that, that they have got a duty to
6 do it. They can't simply bypass the industry, so the industry certainly
7 has the ability and other players ability to input into the decision-
8 making.

9 **MR KOS:** I accept that certainly where the rule change is in the hands of the
10 EGB.

11 **CHAIR:** I think just to follow, as was said earlier, any person can propose a
12 rule change to the Minister under the Crown model, and it's the
13 Minister's call whether or not he or she asks those persons to then
14 contribute to the rules, or anybody.

15 **MS BATES:** It's the EGB who must go and consult the board. That's under 172.Y,
16 EGB must formulate in regulations consult with the persons - so it's at
17 that level that there's consultation before it actually gets to the
18 Minister. It's not the Minister's obligation to consult. I'm just
19 saying you've got to be fair about it and say that there is some
20 participation at that point. I do accept that it's a different process.

21 **MR MURRAY:** Our contention was that that process is less information rich than
22 the industry EGB decision process.

23 **MS BATES:** Could you just elaborate on that, because if there's a duty to
24 consult then industry can get in and say what it likes. So, why is the
25 information better under your proposal?

26 **MR MURRAY:** At the end of our process that final decision on whether to
27 implement a rule or not lies in the hands of industry participants who
28 must comply with that rule. There will be information that they have
29 which is difficult to accumulate or aggregate at the centre.

30 The only problem of centralised decision-making is understanding at
31 the centre all of the information that is held in the hands of the
32 participants. To pick up an example of that, in the design of the
33 market, the current spot market we have bid and offers coming through in
34 a price form because it's too difficult at the centre to aggregate cost
35 information on the operation of generation plant, so prices are found and
36 then individual generators choose or determine how they operate their
37 plants according to that price information. When that type of concept
38 was introduced and it was first introduced in New Zealand, there was
39 concern that it was impossible to operate an electricity system that way
40 the England and Wales market had cost information being accumulated in
41 the centre.

42 A similar example with the detailed design of rule changes. Some
43 information is not easily aggregated at the centre because we don't know
44 in advance what is the important piece of information for the decision.

45 **MS BATES:** I am really making a serious effort to follow you exactly, but we
46 have the EGB, Crown EGB on one side of the equation, making a
47 recommendation after consultation. Do you define the Crown EGB as being
48 at the centre?

49 **MR MURRAY:** In that example yes.

50 **MS BATES:** In that example, so it's difficult you say for it to accumulate all
51 the information from the industry participants who would make submissions
52 to it?

53 **MR MURRAY:** Yes. And to evaluate the trade-offs that are inherent in that
54 information.

55 **MS BATES:** Why is that if the Crown EGB has people on it with the right
56 expertise, why couldn't they get a handle on the right information?

57 **MR MURRAY:** They may in some circumstances but not in all. To give another
58 example. To set a common technical standard, to find an efficient level
59 of a standard that's common across a raft of different participants
60 requires a trade-off of the interests of all of those participants.

1 Decision-making having a third party decide ultimately what that common
2 level is, tends to be less efficient than a process that allows for the
3 revelation of that common level.

4 A practical example of that would be the setting of the under
5 frequency standard for generators. It was an issue in this country for a
6 number of years when we didn't have a decision process in order to settle
7 that. It's been addressed through the MACQS process now and finally the
8 industry has come to a resolution as to how to set those technical
9 standards.

10 **MS BATES:** Are you saying that an independent body could not have reached the
11 same result after hearing from all the interested persons, is that where
12 you're coming to.

13 **MR MURRAY:** I'm not - it could not have reached a result, it may well have
14 reached a different result.

15 **MS BATES:** Can you actually say positively that it would have reached an
16 inferior result, are you actually able to say that?

17 **MR MURRAY:** I can't say on any particular example whether it would certainly
18 have done that. I can say that the economic literature associated with
19 information and the cost of transferring information would argue that
20 over time it would tend to reach inferior results.

21 **MS BATES:** So that's what you're basing that proposition on, economic
22 literature.

23 **MR MURRAY:** Yes.

24 **MR CAYGILL:** There's a stage missing in the Crown EGB as distinct from the
25 industry EGB process, there's a stage missing, more than one stage, but
26 the ultimate stage in the industry process when a working group has tried
27 consensually to hammer out the optimal rule that's been checked against
28 the guiding principles, there's no lack of conformity there so this can
29 go through to a vote. That voting process involves every individual
30 participant saying how will this affect me? Is this something that I can
31 live with, that I can work to, is this a better under frequency standard,
32 is this a better price discovery mechanism?

33 The Crown EGB can replicate all the processes, save that last one.
34 It could choose, it could - we can imagine a world in which a Crown EGB
35 only changes rules after a consultation process which clues a vote, but
36 there's no provision for that in the legislation and it would be a
37 strange Crown entity I think that subjected itself simultaneously to that
38 risk and its obligations to the Minister. I think it's safer to assume
39 with respect that there's no equivalent final process in the Crown
40 system. So, the central process does its best, on any individual
41 decision you may well end up with exactly the same outcome, but the
42 quality check if you like available in the industry process, not being
43 present in the Crown one, it is not unreasonable over time to imagine
44 will lead to inferior outcomes. That's the argument.

45 **MS BATES:** I really want to explore this because I know it's one of the nubs of
46 the case, I just want to spend a bit of time on it. I want to be
47 absolutely crystal clear on it. When the EGB, the Crown EGB consults and
48 has the industry players making submissions to it why would those
49 industry players not make their submissions in accordance with their
50 self-interest, just in the same way as they would vote in accordance with
51 their self-interest?

52 **MR CAYGILL:** They clearly will and one can next assume that on a difficult issue
53 they will make contradictory submissions. Some will argue for a
54 particular standard some will argue for something else.

55 **MS BATES:** Such as some will vote one way and some will vote another way.

56 **MR CAYGILL:** The processes that the governing body, the Crown EGB will use don't
57 typically - I think this is not unlike the process of an inquiry getting
58 several - getting a number of submissions and saying well what do we make
59 of all of that? One can't readily say well X's submissions should be
60 worth so much, representing the value they have at stake and Y will

1 attach --

2 **MS BATES:** So you think it's cleaner if you've already evaluated whose vote
3 counts more and you get a clean decision.

4 **MR CAYGILL:** I think a two stage process where the central body seeks, in the
5 industry case the working group, in the Crown's case the governing body
6 itself, seeks to discern the optimal outcome from the submissions. That
7 is a similar process. So, you consult, you listen, you question, you
8 evaluate the conflicting views about what the rules should be and you
9 formulate an outcome. But the Crown EGB stops at that point, says to the
10 Minister well, here's our recommendation, we've listened as best we can
11 to everybody, there's a conflicting view, we think the right outcome is
12 X. The industry does that but then submits it back it a process that
13 allows people to say no, for goodness sake, you got it wrong, somebody
14 might have told you that was a good outcome, but most of us think that
15 that is not as good as something else.

16 **MS BATES:** Let me put this proposition to you. Couldn't you say that the people
17 with the greatest voting power may not - may well, not end up with the
18 right result? If they're voting in accordance with self-interest, could
19 you not come - could you not arrive at that situation in a particular
20 case?

21 **MR CAYGILL:** In a particular case I don't doubt that's so. With respect, I
22 think what you're now heading into is a very important issue, but it's an
23 issue about not the difference in processes, but the question of whether
24 the votes themselves A) are allocated correctly and B) --

25 **MS BATES:** But that's a very important part of the integrity of the decision-
26 making process isn't it?

27 **MR CAYGILL:** Yes, it is. The issue with respect, the prior issue that I think
28 we're engaged in is whether there's value in a voting process. Whether
29 that on balance, taking a range of --

30 **MS BATES:** I don't know if you can answer that in a vacuum unless you know how
31 the votes are allocated. I see the two as being integral.

32 **MR CAYGILL:** I understand one - I understand that, but and ultimately you'll
33 have to assess both aspects because they're both part of our application,
34 but the precise issue I think that goes to the difference in approach is
35 the simple point in the applicant's - in our submission, that the absence
36 of a final check is likely to reduce the overall quality of outcomes over
37 time and frankly it seems to me not that this disposes of the issue, but
38 when I ask myself the question well, why would the Government have
39 favoured self-regulation? Where did that come from? What was that
40 about? I don't think it's because they favoured an easy life. They
41 thought they could pass this off, this responsibility off to the
42 industry.

43 That doesn't work because they're still publicly accountable and
44 they've still got the power of intervention. I believe that the
45 Government's assessment, its preference for self-regulation is a
46 judgment, the Commission's not bound by this reasoning process, but the -
47 I believe that the Government itself is saying self-regulation will over
48 time lead to better quality outcomes. Indeed we've put in front of you
49 the Minister's view of that.

50 **MS BATES:** That's a high level consideration of course.

51 **MR CAYGILL:** Yes.

52 **MS BATES:** But just coming back to this voting question. I'll think about it
53 overnight. But I for one remain to be convinced that a voting process of
54 itself necessarily leads to better outcomes. I would need to have
55 factored into my decision the voting allocation, I think. But I'm not
56 definitive on it, but that's my thinking at the moment.

57 **MR KOS:** Can I invite you then as you are thinking about it overnight, perhaps
58 Commissioner just to reflect on three things in particular. One is the
59 break point in this discussion at the moment is whom are you proposing
60 the decision in. Is it in the stake-holders themselves, or is it in an

1 independent body that somehow poles those stake-holders, or a Minister
2 who receives a report on the pole?

3 **MS BATES:** Well, the EGB makes a recommendation. It doesn't make the decision,
4 we know that.

5 **MR KOS:** Yes, I know but the difference is still the one I identified, which is
6 one of whether it's the stake-holders who make that decision, or someone
7 who reflects on the views expressed by stake-holders in which there is no
8 inherent --

9 **MS BATES:** Of course what we have to do is evaluate those two --

10 **MR KOS:** Yes, but in the expression of the stake-holders views there is no
11 necessary priority of one of the other, all are equally capable of going
12 and banging on the Minister's door, all are equally capable of going and
13 getting a fine PR firm to write a magnificent submission. The voting
14 methodology provides a method of discrimination which is not necessarily
15 available. Hang on to that proposition for a moment.

16 **MS BATES:** Say it again, the voting methodology --

17 **MR KOS:** The voting process provides a method of discrimination which is not
18 available if it is simply a question of lobbying the presentation to a
19 third party which either makes a decision, or makes a recommendation but
20 is not itself a stake-holder.

21 **MS BATES:** So it's lobby-proof?

22 **MR KOS:** It's not lobby-proof but it is superior transactionally. That's the
23 first argument.

24 **MS BATES:** Do you say it's less susceptible to lobbying at that point of the
25 decision-making process?

26 **MR KOS:** Yes.

27 **MS BATES:** Is that a point you're advancing?

28 **MR KOS:** Yes. There is inter-se lobbying isn't there between the industry
29 participants prior to the vote. Of course they're going to talk to each
30 other and seek to form coalitions. That's good. No-one's saying that
31 shouldn't occur. But it is the stake-holders making that decision.
32 First point.

33 Second and third points can go together. They are to refer, in
34 addition to the point that David just made about the Minister and
35 Parliament's perception that self-regulation and therefore the industry
36 by that should make those decisions subject to the constraints expressed
37 in the legislation. There is a respectable reason apart from political
38 instinct on that particular point and that's experience of history.

39 **MS BATES:** Is that something different from the experience referred to, what
40 has been referred to as what's in the economic literature?

41 **MR KOS:** Well, that's a very general expression. Let me give you two specifics
42 pieces of economic literature. One of them is the World Bank study which
43 is referred to and someone will give me the reference in a moment to
44 that, because I haven't got it at my finger tips, but which is referred
45 to in LECG report and it's in the notes in front of you.

46 The second one is the Treasury Study on investment in generation
47 infrastructure in this country in the 1960's through the 1980's, which is
48 set out in answer to question 20 in Contact Energy's submission. That is
49 also worth looking at because that is feet on the ground economic
50 literature which we can have reference to. That's all I want to say
51 Mr Chairman.

52 **CHAIR:** I think I might draw it to a conclusion. But I think, so we're clear
53 where we've got to at the moment, we're working through the decision-
54 making processes of both structures. Just another question you might
55 ponder over, if I had the largest number of votes under the industry EGB
56 and, as you say, this is known and my influence on the process is known,
57 is it a fair proposition that under a Crown EGB, if I have the same
58 number of whatever it is kilowatt hours or whatever, that will give me
59 those votes under an industry EGB, could I be expected to lobby the
60 Minister to make sure his or her decisions reflected the weighting I'd

1 have in the industry EGB. Part of your argument as I see it too is the
2 ability of major players to lobby the Crown EGB in one form or another is
3 unknown, whereas the voting structure and consequence of those votes is
4 known. So, that all things being equal the colour of the argument is
5 clear. So, you may just want to make a comment on that tomorrow.

6 **MR CURTIN:** Just in terms of the evidence that's been put in front of us from
7 the World Bank and the Treasury study, I think they're suggestive in
8 their own ways. But I think the Treasury study is perhaps relevant to an
9 era in the 60's and 70's and 80's that perhaps isn't terribly useful any
10 more and we were very dirigiste back then and no longer so and the World
11 Bank study is very much about developing economies with their own
12 problems of corruption and inexperience and what have you.

13 While you've sort of going away to mull over what else you might
14 say on this issue, it would be very useful if you could find other
15 evidence on this general point of the superior efficiency or otherwise of
16 private sector as opposed to public sector, major investment decisions.
17 It's quite possible that some of the literature on privatisation, or
18 corporatisation, or indeed literature from other network industries or
19 industries where there are large lumps of fixed costs, if you could draw
20 our attention to any further material on those issues, that would be very
21 helpful from my perspective.

22 **MR KOS:** Thank you, we'll look for that.

23 **CHAIR:** If there aren't any further comments I'll draw today to a close until
24 tomorrow at 9 o'clock sharp. Thank you very much.

25 **(Hearing adjourned until 9.00 am on 13 June 2002)**

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