(Hearing resumes at 9.00 am on 13 June 2002)

CONTINUED SUBMISSIONS OF
ELECTRICITY GOVERNANCE BOARD LIMITED

CHAIR: Good morning everyone. I suggest as it's just past 9 that we resume. Just before asking EGBL to pick up their submission I think Donal Curtin has one question he'd like to ask.

MR CURTIN: It was really a fairly technical question about the benefits in the draft determination attributed to the superior quality of decision-making by an industry body as opposed to a Crown EGB. I think in your submission you've basically agreed with the draft determination's quantification of the benefit, except for one adjustment relative to how you measure a dynamic efficiency. I just wanted to establish for the record that that was your position that you were happy, other than that point, with the draft determination.

MR KOS: Can I say I'm absolutely delighted that that particular point's been made. The point I'd like to just open today on, with a remark or two, on where we're at. We spent a very long time yesterday Mr Chairman, members of the Commission, justifying the proposition that a self-regulatory body has superior decision-making qualities. I want to say to the Commission that must be in the first instance a matter of instinct and secondly, a matter of analysis.

On instinct, in my submission, we do not need to spend a long time reaching that instinctive view. It's implicit, as Commissioner Curtin's just said, in the draft determination with which we agree. It underlies Parliament's preference expressed in the legislation which leaves space for that preferred position. It's implicit in Government's preference. It is implicit and indeed explicit in the Government policy statement. We can find it in other decisions that this Commission has made.

One that comes to mind is the number portability deed where at paragraph 261 of decision 356 the Commission said this:

"Professor Ergas and Mr Sundakov on behalf of Telecom emphasised to the Commission the advantages of industry self-regulation over Government regulation. Costs can be expected to be lower, incentives to improve efficiency to be greater and flexibility to be enhanced with the former. The Commission accepts these benefits and has given weight to them in its assessment, with the benefit to the public arising from the deed".

So consistently we find that not only in the draft determination, but also in earlier decisions on this Commission, subject only to some observations, we want to make the moment on Professor Hogan's supplementary paper, and the Transpower submission. We do not think we would want to take the Commission's time much further on topic number four.

I said it's a matter of instinct first and then analysis. As to the analysis, we've shown the Commission amply I think where the opportunity for the input of superior decision-making and participant decision-making comes into the industry body. We see it embraced at two levels, both in the working groups and also in the voting procedures. In the Crown EGB we've seen the possibility of participant involvement in the working groups but that's it. The rest is consultative, not determinative.

So that's the opportunity element of analysis. The other element is the question of value, and coming back to Commissioner Curtin's observation, yes, that's the point at which we have a slight point of difference with the draft determination. We have a different view about the value in terms of dynamic efficiency and Doctor Hansen will say something on that a little later.

So, Mr Chairman that's the a very long way of saying yes to Commissioner Curtin's observation, but something we wanted to say at

beginning of this morning.

CHAIR: I note what you said and we certainly will take notice of it. So let's move on to item 4 I think on your list. Hang on, item 5.

MR KOS: Might we just - before that, as I said Mr Chairman, we wanted to make a couple of observations on Professor Hogan's. We'll do that now if we may.

CHAIR: That's fine.

MR MURRAY: In his report Professor Hogan refers to the bad experiences in several of the United States states, especially in California. He makes a point that industry self-governance can lead to bad design and worse decision-making. The inference, and one certainly taken by Transpower in its submission from Professor Hogan's paper, that a similar outcome can be expected in New Zealand under the proposed arrangements. We'd like to make three points in response.

First we'll comment on whether it is reasonable to infer from Professor Hogan's observations that the industry decisions were primarily to blame for the events in California.

Secondly explain why it is not reasonable to infer from Professor Hogan's comment, or particularly from the US experience that the proposed industry arrangements would result in bad market design in New Zealand.

Third we explain that Professor Hogan's report does not address the governance designs that are in front of the Commission.

In relation to California, Professor Hogan's report is a brief report, does not cover the critical role played by the California Public Utility Commission. We note that Professor Hogan and 30 other commission professors, former public official consultants, prepared a paper in January of 2000 on the California electricity crisis where they concluded and I'm quoting from item 5 in the notes prepared by Russell McVeigh.

"the crisis had its origins in mistakes and miscalculations at the time the electricity sector was restructured, two key shortcomings stand out. First, utilities were strongly encouraged to divest a substantial proportion of their generation while being locked by the CPUC, the California Public Utilities Commission, the state regulator, were blocked by CPUC regulations from entering into stable long-term contracts. Second, California froze retail rates at low levels and banked on low wholesale prices to support a profit margin high enough to enable the utilities to pay off the historical uneconomic investments".

It's no doubt that bad decisions were made, bad design decisions were made by stake-holders in California and the California market bears no resemblance to the market arrangements being considered by the Commission, but the two key shortcomings according to the paper prepared by Professor Hogan and 30 of his peers, were decisions by the state regulator.

We have an easily digestible and comprehensive review of the California experience can be found in a paper by Professor Bernstein, entitled "The Problem Trouble With Electricity Markets Understanding California Destruction and Disaster", which we've attached to the back. It's one of those rare papers written by economists that's reasonably easy to read.

MS BATES: Sounds good.

MR MURRAY: The second point we'd like to make is what inferences can we draw from the United States experience for the New Zealand design. We note that the New Zealand first industry agreed arrangement MARIA, the metering and recirculation and information agreement was negotiated by the industry in 1994, NZEM became operational in 1996, again an industry negotiated arrangement. The maximum arrangements came in subsequent to that at the governance structure, again an industry agreed arrangement.

MARIA was substantially reconstructed to allow for particular consumer switching which came into being in 1999 and the industry for its

own initiative was close to implementing a merged NZEM and MARIA in late the year 2000 prior to the Government policy statement and now again for an industry negotiated process, has completed that merger and extended it to encompass the MACQS or the common quality arrangements and transmission. The New Zealand market model is entirely a product of stake-holder negotiation, within a carefully designed and structured decision process. If industry voting arrangements necessarily led to a least common denominator solution that sacrifices efficiency as suggested by Professor Hogan, then the New Zealand market model by now would be showing serious flaws and be viewed as a failure.

We submit that that's not the case. Neither the Government's inquiry into the electricity industry, nor its recent winter review following the high spot prices of last year, reached such conclusions. Professor Hogan has also been generous in his comments on the New Zealand market design. In March 2001 he submitted - Transpower submitted a paper by him to the New Zealand Commerce Select Committee that he stated, and I quote

"New Zealand has an excellent market design and there has been broad agreement on the direction of further development" and has recently published a review of the electricity market restructuring, which is cited in his paper to the Commission, Professor Hogan stated, and I quote

"In many ways the New Zealand market design has been at the forefront of best practice".

We submit that the New Zealand experience shows that industry decision process, if carefully designed, and subject to oversight by regulatory bodies such as the Commerce Commission, can result in "an excellent market design" and a design that is "at the forefront of best practice".

The third point I'd like to make is the relevance of the United States decision-making experience. Professor Hogan cites the PJM as a positive example of the benefits of the regulated approach, but the PJM approach does not correspond to either of the governance structures being considered by the Commission; that is it does not correspond to the arrangements proposed by the industry, nor to the counterfactual.

In PJM an independent board determines the rules, the final approval by the Federal Electricity Regulatory Commission, FERC. No elected politician is involved in the decision-making. Furthermore, the decisions of FERC are heavily constrained, relative to the proposed Crown EGB, by statute that governs FERC by regulatory process, including the generic Federal Administrative Procedures Act which requires notice of pending decisions and an opportunity to comment and the US Constitution, an example of constitutional constraint include the constraint against regulatory taking.

There is no such constraint that applies to the actions of the Minister and Crown EGB under the proposed counterfactual. There are no equivalent constraints on the Minister and the Crown EGB to those that occur on the regulatory authorities in the United States. There's no constraint under a Crown EGB, for instance for a Minister agreeing to a rule change that would undermine fundamentally the basis on which substantial investments had been made. An example might be an alteration to the dispatch rules that would favour renewable energy over thermal plant. Also, we note that as we have said in the submission, that the decisions and rules of a Crown EGB would not be subject to the Commerce Act. The industry arrangements are clearly subject to the Commerce Act.

We have not been able to find an electricity market in which a Government Minister has discretion over the rules in a way that's proposed for New Zealand. We believe that an Alberta Minister has discretion over the voting rights, but not over the rules themselves. Still checking confirmation of a number of those facts and we'll submit them to the Commission later.

It's not surprising to us that very few jurisdictions allow ministers to determine operating rules of an electricity market. In the December paper prepared by Eric Hansen and myself that accompanied the application, we cited at paragraph 165 some of the literature concerning industry performance generally, and concluding that industry performance generally, and investment specifically is depended upon the degree to which the unpredictability of Government action is restrained. That's the literature around credible commitment in policy making.

For example, closer to home, what goes wrong when decisions are allocated to a Minister in a Crown EGB with few constraints or with wide powers? I refer the Commission to the recent book by Dr Graeme Scott, former secretary to Air New Zealand, Public Management in New Zealand, pages 269 to 312 and I'm having those papers copied for you, where Dr Scott discusses the New Zealand experience with Crown entities and the type of procedures and constraints that are important to ensure sound decision-making over time and we note that those constraints are not evident in the Crown EGB model.

So on a comparative institutional approach, if we accept the counterfactual of a Crown EGB, then the institutional choices seem to us are between an industry process, which over a period of seven years has resulted in the design of a New Zealand Electricity Market being described "at the forefront of best practice" by the world authority on electricity market design, Professor Hogan, although he would apparently prefer the PJM governance regime, a regime that is not an available option to New Zealand, at least to the Commission in terms of the counterfactual.

The alternative to that is a ministerial and Crown EGB decision process which, in the form set out in the Act, is untried anywhere in the world that we can find in an electricity context, and is unsupported by any publicly available analysis that we've been able to find, and which the analysis which Dr Scott sets out in his book in some detail, and Dr Scott is a world authority on the institutions of Government, and in particular an expert on the institutions of New Zealand's Government, suggests will lead to core outcomes. Those are the comments I wish to make.

CHAIR: Thanks Mr Murray.

MR CURTIN: Just one very quick one on the PJM. I think a lot of us are reasonably familiar with what happened in California just from the general financial press. But PJM had some interest because it was something not so immediately obvious and it was quite interesting to have our attention directed to it. I hear what you say perhaps about the lack of parallels, but is there anything in the PJM experience that you'd like to point to that would be of positive value that could be transferred to the New Zealand environment and give us something to think about?

MR MURRAY: New Zealand has certainly learned from the PJM experience, and I hope PJM may have learned from some of the New Zealand experience. The parties here who have developed the rules have studied closely the PJM experience. One area that I'm sure Professor Hogan will raise is a gap in the New Zealand market design, the financial transmission rights and that is an element where New Zealand certainly lags the PJM. The debate is a long way down the road here. It's proposed that there would be a design in place this year. Whether it achieves it in this year, it's certainly not far away. We would agree with Professor Hogan that that's an important element that's missing from our market that PJM has managed to implement, but there are other aspects of the PJM where the New Zealand market is perhaps ahead of PJM. The customer switching, deem profiling, PJM is behind New Zealand on that.

I think the common quality arrangements where we have much greater involvement of industry in setting the common quality, and yet untried

the proposals around transmission, particularly around the service definitions of transmission, again we haven't implemented that, so we can't count it yet but it appears we think - our thinking on that is slightly ahead of PJM.

MR CAYGILL: The inquiry actually identified financial transmission rights as an area worth pursuing, partly following submissions from Transpower to that effect, and partly following a visit that the inquiry had made to the PJM market.

CHAIR: I just have one question before asking you to resume. As I understand it, and I had a look at that paper yesterday evening I must admit, the nub of the Californian problem was capacity being taken out in some areas and no ability to recover price increases at a retail level, to put it simply.

MR MURRAY: That precipitated the crisis, some important lessons, why was the capacity not there. Then I think some of the answers go back to actions of the regulator in constraining prices and constraining - there are significant resource constraints on the creation of new generation, a number of factors that fed into the crisis, but the immediate point was that they were short of capacity and fixed prices at the retail level, which meant a financial crisis for the incumbents.

CHAIR: Thank you very much. With no further questions, perhaps we might move on to, I think number five is the next one.

MR KOS: Thank you Mr Chairman, number five follows closely number four. One of the applicant's presenters on this topic in particular, Mr Alexander from NZEM is not present because, in an attempt to ensure we don't lag too far behind PJM and FTR's he's meeting with the commission and I think Transpower on that topic at this very moment. So we might have to take part of this a little later when Mr Alexander's here, if that's okay, out of sequence.

This is an important topic in terms of the draft determination and our submissions on it because the Commission had concluded in its draft determination that there was a prospect for some pro-competitive rule changes to be blocked or delayed by existing market participants. The applicant's response to that is twofold.

First, we say that that pessimistic assessment is not correct and we'll show why. Secondly, we say that the real cause for pessimism in fact is under the counterfactual with the prospect of the grid owner and system operator blocking pro-competitive changes and so we say therefore, that the outcome between the two alternatives is, if not neutral, then in favour of the proposed arrangement.

The draft determination assessed the net public detriment of the potential for blocking pro-competitive changes by industry participants at some $33m to $72m which obviously we are disagreeing with. On the other hand Messrs Murray and Hansen assess the detriment under the counterfactual from the transmission owner system operator blockage of pro-competitive rules at some $50m to $105m so that's the context in which the debate is set.

Our responses to this part of the topic are set out in paragraph 5.7 on page 26 and we begin by frankly noting in B) that while there are risks of supply-side misuse of power, there are good reasons why that would not occur and we note firstly the lack of incentive and the prospect of the arrangement facilitating value releasing rule changes.

The absence of the power of a single participant to block change, via a vitae, except for Transpower in relation to part F) the transparency of the process and the fact that the voting arrangements encourage coalitions. That's the incentive side on the sanction side. We note that not only is transparency a quality which will operate as an effective discouragement to misuse of power, but there's also the six part review process for EGO's which we reviewed extensively yesterday.

That's the first part of the answer - that's the structural answer.

Then there's the experiential answer which is set out in C). The record in fact shows that the potential for misuse which is already in existence under NZEM has not in fact been exercised, and we refer to the - our submissions on that and the Murray and Hansen paper and their statistical analysis at paragraphs 85 to 86 of that paper. We secondly refer to the NZEM examples which is what Mr Alexander was going to talk to you about and will do so later in the morning, and thirdly there's the Market Surveillance Committee Report, which we'll come on to in a moment and which Doctor Hansen will talk about.

The third important point Mr Chairman is then the counterfactual side. That is the fact that the counterfactual contains its own anti-competitive propensitive advice, which we say is worse on the supply-side risk under the proposed arrangement.

That levers from the fact that the rule change process under the counterfactual, or in fact under either arrangement results in the prospect of devaluation of grid assets which would encourage a grid operator to oppose change.

The next point we make in D.2 is that the system operator can be expected to take a view which is overly conservative in relation to diversity and differentiation and indeed that's something that Transpower itself has acknowledged in a passage which we'll be quoting later in the morning.

The third important point then is having looked at those two instincts and incentives of the grid operator under the Crown EGB, they're likely to have a much more influential role. We note the difficulty of the Minister and the Crown EGB second-guessing the Transpower view and the necessity or the likelihood of the Minister and Crown EGB to be held politically accountable for failing to follow Transpower's views.

We submit then that compared to the proposed arrangement there are very few checks and balances to prevent the grid owner system operator from acting on such incentives under the counterfactual. You don't have the same measure of scrutiny, the same measure of transparency in relation to rule change proposals. So that's our third substantive argument.

The fourth one set out at the bottom of that page is that we have proposed a condition which if necessary the applicant would be prepared to incorporate into the arrangement. This is proposal one. It provides some additional transparency and oversight through either a second vote option or a second vote plus appeal to the Rulings Panel and the Commission will of course be familiar with that proposal.

So for those reasons we submit it's incorrect to conclude that there's a net public detriment under the proposed arrangement. In fact, having regard to the risks under the counterfactual we submit there's a net public benefit. I'll ask Mr Hansen to talk about the Market Surveillance Committee Report. What we might do is to get Mr Hansen to at least cover off the NZE example so we can take them in sequence and Mr Alexander can add anything that needs to be added later.

CHAIR: I think it would be very interesting from the Commission's point of view because the Market Surveillance Committee has played a role in the market since its inception, and there may or may not be some pointers to the way the new rules are going to work. So, please, Doctor Hansen.

MR HANSEN: Thank you. Beginning with the Market Surveillance Committee Report, I note we've included that in the documents in the back in full, so that the Commission may refer to that if it wishes. But beginning with that, starting with Transpower, in paragraph 51 of their submission, really make the point that vertically integrated generators have and in fact are exercising market power and it's the basis of their claim that the generators will do whatever to retain that ability, or that exercise of market power and Transpower do not directly quote the Market Surveillance

Committee but they say the Market Surveillance Committee report of 17 July 2002 supports this claim, in particular that the vertically integrated generator retailers are exercising market power.

Point B on page 28, we just wish to point out that the Minister did not say that the vertically integrated generators are actually exercising market power, more than transitorily. I refer the Commission to pages 16, 27 and 28, particularly of the Market Surveillance Committee's report where they summarise their conclusions regarding retail market, edge market and the spot markets, and in each case the Commission does not find evidence that the generators are actually exercising market power as opposed to having the possible capability to do so, for more than a transitory period.

The second point in regard to Transpower's submission and their use of the Market Surveillance Committee report refers to the Market Surveillance Committee's supposed concern regarding oligopoly in the New Zealand market. We believe that Transpower has taken this somewhat out of context and over-emphasised or expanded on the Market Surveillance Committee's concern about oligopoly. What the Market Surveillance Committee actually said with respect to oligopoly was, when you read it in the context of the two to three pages that the committee did spend on it, first that there are actually relatively few firms in any electricity spot market world wide. These markets are best described as oligopolies, in other words that New Zealand would not be much different from overseas experience.

In the committee's view NZEM is or is tending to oligopoly. As a result it is likely that the particular market participants will have and be able to use market power from time-to-time.

Then near the back of the report, on page 31 that oligopoly and vertical integration may tend, as a matter of fact, to lessen new entry to the electricity markets. However, given, and this is the bit not included by Transpower, however given the size of the New Zealand markets, oligopoly may well be the natural structure.

I believe that the Commission, that this is relevant in any comparison of the proposed arrangement versus the counterfactual, namely, that oligopoly would be present in both situations, if indeed it is present.

The Third point regarding the Market Surveillance Committee Report is the Market Surveillance Committee's concern over rule changes. It is correct to note that Transpower note that the Market Surveillance Committee, on page 35, expresses concern that New Zealand electricity market rules have evolved somewhat differently to what might have been anticipated at the time of the set-up of NZEM.

The Market Surveillance Committee does not explicitly say what the causes of that were. It does refer to oligopoly, but we would note to the Commission that the Market Surveillance Committee did not have the benefit of the study that we have provided to you on NZEM rule changes, and as far as we're aware, and Mr Alexander can comment on this, did not undertake a similar study of that nature.

Then finally, just in regard to that, we would note in terms of the proposed arrangement the several improvements that are incorporated in the rules, such that would help to mitigate any concern in that area, and these relate to the fact that any person, not just participants, can propose a rule change. Second, that the industry EGB would be independent and therefore has in the rules the ability to set the priority of rule changes and the removal of the Transpower consent requirement that is currently in the NZEM rules.

We believe these three factors are significant improvements in the new rulebook relative to NZEM that go some way, or quite some way to addressing the concerns identified by the Market Surveillance Committee.

Moving on then to the section 5.9 in our notes about the claimed

examples. We also wish to question the various examples put up by Transpower and some other submitters on the implications of various examples.

Starting with financial transmission rights. Transpower in paragraph 59 claim that this is an example of industry delaying a pro-competitive rule change through ongoing debate over introduction of FTR's. We submit two points on this. One, it is evident that not only generators but other parties have problems or concerns with the design proposed by Transpower, irrespective of whether that design actually is the right design or not. It is clear that other parties have problems with it and we note in particular the major energy users group has expressed significant concerns with that in a letter dated 5 February this year. That is included in the documents in this compendium, along with a number of other letters.

Included in the document with those letters is also an e-mail message from a Mr R E Sergeant of Meridian, where he sets out quite clearly the types of concerns that they have and we believe, the Commission, that indicates genuine concerns about design rather than just delaying tactic.

Moving on to loss and constraint rentals. Transpower at paragraph 49 note that the NZEM Rules Committee rejected a recommendation by the Market Pricing Working Group regarding the allocation of loss and constraint rentals, and appears to be implying that the Rules Committee rejection was somehow improper and anti-competitive. In fact, reviewing the minutes of the relevant meetings of the Rules Committee, it is evident that the recommendation from the Market Pricing Working Group was rejected because the committee considered that the group had not analysed the original design objective, whether the original design objective had been achieved. We would submit to the committee that that is an entirely appropriate function of the Rules Committee to make that judgment.

We would also note that the Rules Committee did not delete or kill the proposal, but rather requested further work on the issue. These facts do not support Transpower's claim of anti-competitive actions with market participants in NZEM.

C) Publication of bids and offers. Paragraph 5 of the Transpower submission suggests that industry has forward proposals for bids and offers to be published for anti-competitive reasons and we refer the Commission to the paper that Kieran Murray and myself wrote, particularly annex 2 which summarises the various proposals and outcomes and notes there, and there have been I think four separate proposals in this area, ranging over a number of years. Three key facts stand out to us in this particular case. The NZEM received conflicting reports as to whether the proposal would be pro or anti-competitive. The first report that it had said that it would be pro-competitive.

Sorry the first report suggested that it would be pro-competitive. The second report that it would in fact be anti-competitive.

MS REBSTOCK: Who prepared the reports?

MR HANSEN: The first report was prepared I think by a consultant to Market Surveillance Committee Co, called Stephanie Post. I think the second report was prepared by myself when I was a staff member of M-Co, and was in fact reviewed independently and at that time I had no association with Mr Murray, and by Doctor Lewis Evans who is a member of the Market Surveillance Committee. Both reviewers endorsed the conclusions of that report that I made that the proposal was potentially anti-competitive.

CHAIR: There has been an agreement for a four week time delay now isn't there, that's been agreed by the Rules Committee?

MR HANSEN: Well, we are aware that subsequent proposals have gone through and the point that we're making is at the time that it was considered, the Working Group and the Rules Committee had genuinely conflicting reports on whether it was pro or anti. The issue is not whether at this time we

consider the issue to be pro or anti-competitive, but at the time the decision was made, what was the advice given to the committee, the relevant committees? At that time it was clearly conflicting and the reports went into some, certainly the report I wrote, went into quite some detail and quite some literature on why it may be anti-competitive.

CHAIR: My question is I'm not getting into the substance of the authorisation application that currently is in front of the Commission, but I understand that there was a decision of the Rules Committee to look at a four week period, but anyway --

MR HANSEN: That's correct. Mr Alexander would be in a better position than I to comment on those issues.

The second point just in regard to bids and offers, we note that the rules of NZEM provide protections for market participants against release of information that may disadvantage them and the Market Surveillance Committee in those earlier proposals ruled that release of the information would be of a commercial disadvantage, materially commercial disadvantage a participant, in that it was also evidence taken into account by the relevant working group and the Rules Committee at that time. As noted the proposal's currently being considered by NZEM.

Moving on - so again we would argue, although there's a long, a fairly significant history of proposals there, we would argue that it is actually difficult to see clear evidence of anti-competitive or delaying tactic on pro-competitive rules. We would submit to the Commission that these are in fact complex issues that require significant debate and that is entirely a proper process that has been followed.

Mandatory hedges, Transpower submit on paragraph 54 that the industry has failed to develop hedges for anti-competitive reasons. We simply note that NZEM itself records no person has in fact lodged a proposal for NZEM to develop a hedge market. We also would note that there have been no restrictions on parties engaging in hedge transactions bilaterally. So we fail again to see how that is evidence of anti-competitive behaviour.

Moving on to the Cobb Power dispute. Transpower claims that its dispute with Trans Alta is evidence that vertically integrated generator retailers will vote in the particular interests of their business, of the generator side of the business. Again, we would question whether this is evidence and point to three factors in this regard.

One, that exactly identical dispute was held at exactly the same time between Meridian and Transpower and at that time Meridian had no significant retail base argument being made that a vertically integrated generator retailer was making some specific action, as a result of being a vertically integrated retailer does not seem to stack up in that regard. We note also that Transpower has had available the option of testing its proposals by taking a quantum meruit case and has chosen not to do so.

We therefore would argue, whether Transpower's proposals or Trans Alta's were efficient, remains to be tested and proven.

Finally in that regard, we also note that the Cobb Power and Meridian disputes were matters that did not arise under the rules of the various arrangements. They were in fact decisions or disputes outside of the rules and of a normal commercial nature. So, again we believe these facts do not support Transpower's claim of anti-competitive independence.

Turning to the ex-ante market, a submission made by the Sustainable Energy Forum in relation to question 11 in the draft determination. We initially were not clear what exactly the SEF was referring to in terms of the ex-ante market. We did engage in some correspondence and that correspondence suggested that SEF were concerned about the commitment market and it is correct that the original rules of NZEM did have a day ahead commitment market when it was established or became operational in 1996, and that it was subsequently removed by vote in 1998.

We would submit to the Commission three facts that suggest that this was not an anti-competitive move, the deletion of the day ahead commitment market. One, the fact that the commitment market did not provide ability to hedge against transmission price risk. So, it was not providing the function that some people thought it may have. That no trades had occurred on that market in the two year period that it was in operation, and thirdly that the rule change to remove that market received 100 percent vote, not only by generators but by purchasers. If purchasers were concerned about the removal as being anti-competitive it's difficult to see why they would vote in favour of removal.

These votes more-over took place before the substantial vertical integration between generator and retailers occurred. So, again, we do not believe that this is an example of anti-competitive rule change.

CHAIR: Presuming it's best to ask Malcolm Alexander in relation to any further discussion on it, on ex-anti market subsequent to that when he's here.

MR HANSEN: I think that would be appropriate, and I think probably in terms of the last example, removing of demand bidding requirements, that would be most appropriately addressed by Mr Alexander as well, rather than by myself.

CHAIR: Thanks Mr Hansen. Doctor Hansen.

MR CURTIN: I wonder if I could just ask some questions in particular about the publication of bids and offers and noting the chairman's comment earlier that there is an authorisation application in front of us on that issue, and nothing I'm to put to you should be read in that context in any event. But there was quite a widespread theme from various submitters, not just Transpower, about delays to pro-competitive rules, people suggesting they died in working groups and all the rest of it.

But on the publication of bids and offers, could I suggest to you that the history of that issue in the NZEM does not have a good look, that it took a very long time. There were perhaps debatable reasons for that in terms of the report about whether it was competitive or not. But it could be read as a fairly systematic filler buster to prevent what looks like a remarkably basic element of an open competitive market which is publication of prices and quantities, and I do note towards the end of the saga in the report that you folks did on the history of this issue at page 60, that as late as 2000 the generator representatives voted for rejection, while the purchaser and service provider representatives voted in favour of putting to a vote, which again is kind of consistent with a fairly strict central self-interest agenda as opposed to a common interest agenda on a competitive market, and even on page 61 of the latest Murray and Hansen report there is a comment that the recent votes do adopt publication, appear to have been influenced by strong threat of regulation by the Government, and absent that strong threat, it appears that one of the basic building blocks of an open competitive market would still not be in place.

Now that's the argument I think summarising views of various submitters and just a couple of quotes from your own assessment of the history of the saga. Would you care to add to your previous comments on that issue?

MR HANSEN: Yes, I would, with respect, contest the view that it is a basic building block. There are many blind markets operating successfully around the world, many stock markets have a blind market and are considered to be fully competitive. The key concern identified in the report that I wrote, one of them, and I haven't actually reviewed it since I wrote it, since that time, but I remember quite clearly one of the key concerns is that by making bids and particularly offers available that perhaps all you do then is change the offer and bidding behaviour, and that if you did that that could introduce inefficiencies into the market.

So, I would quite strongly contest the view that it is a basic and

straightforward issue and if that report can be made available to you, it quoted advance economic theory and practise and exactly oligopoly type situations, namely gain theory and I would just submit to you that, at that time it was reviewed independently by two New Zealand experts, including Doctor Lewis Evans, Professor Lewis Evans, who agreed with the conclusion.

So, I just submit that I don't think it is such a straightforward issue as you suggest.

MR KOS: I guess Mr Chairman too that the other point that we should make is that that sanction Commissioner Curtin identified of course translates through to the proposed arrangement in the sense that you still have, and in fact you have a more formal structure for Governmental review performance. So, the same sanction would apply in the arrangement. So, the extent that that has produced the perceived correction, it will continue to do so.

MR MURRAY: I'd add to that, that the other point you referred to is whether the rule change, that an offered rule change was stalled at the Rules Committee point of not being referred to a vote. The current - the proposed arrangements now have an independent board deciding whether to refer a proposal to a rule change, which is a change from the structure under which these proposals were considered where a Rules Committee made up of industry participants considered whether to refer the proposal to a vote or not, and the event that Mr Curtin referred to where the purchasers recommended it go to a vote, and the generator representatives recommended it not go to a vote would not occur in the future because that will be a decision taken by an independent party.

CHAIR: Because at the moment it's the Rules Committee that makes that decision whether to have a vote or not, isn't it?

MR MURRAY: That's correct.

MR HANSEN: Sorry. Subject to over-ride where members by 25 percent vote can call through the proposal.

MR CURTIN: I would note it was perhaps later in the history of things, but the Market Surveillance Committee report which would have been on the event of early 2001 did acknowledge the point that publication of prices could lead to strategic behaviour in theory, but at footnote 25 it suggested that that outcome in fact would be very difficult to achieve.

So, certainly in 2001 from the Market Surveillance Committee's point of view it did not seem to be too concerned about the strategic gaming risk you mentioned.

MR HANSEN: I think that's relevant to the point about the history and note the first proposal on this was made in October 1997 and at that time the market structure was of principally ECNZ and Contact Energy and in that situation with two main players, I would submit that the potential for disclosure to lead to collusion would be quite different from a market where there are say, four or five players.

So, I think that's important in the context of looking at the history and considering whether this has been inappropriately delayed.

MR CURTIN: Just if I could ask a question about the financial transmission rights. I wonder first of all whether you would categorise the introduction of FTR's as a pro-competitive move and accepting that there are perhaps genuine difference of opinion about the particular design in this case, whether you wouldn't have expected the arrival of a potential new instrument for creating a market that wasn't there before, to be welcomed by the industry rather than running into the difficulties that it has.

MR HANSEN: It is quite clear that it is pro-competitive and that the industry in various correspondence has welcomed the move in concept. The issues that the industry have and including the major energy users group are to do with the specific design and implementation approach, not the concept and I refer the Commission I guess to the letters that are in the

compendium from various industry chief-executives to Transpower, consistently stating that they welcome and fully support that there should be an FTR market.

MR MURRAY: I also note Mr Curtin that the FTR product has not been developed within the current rule structure, it has been developed by Transpower outside of the rule structure. So, no FTR type proposal has been put for a rule change to the NZEM.

MS REBSTOCK: I just wanted to come back to the point you made in 5.8, C.3. If I understood your comments correctly you indicated that - this is on page 28 - you've indicated that this structure of the industry would - comes to play in either the proposed arrangement or the counterfactual. It seems to me that's not really the issue, whether it's the structure that is the way we have to analyse this market.

What is an issue for us, when we do competition analysis and cost benefit analysis, is what constraints there may be on the exercise of any oligopoly power in each of the two scenarios and that is the issue, not whether it exists in both under the proposed arrangement and the counterfactual, and I think to that extent just saying it exists in both conditions doesn't do away with the fact that we have to consider the impact of market structure when we look at net benefits.

MR HANSEN: Thank you. The points that we would make there is that under the proposed arrangement the Commerce Act continues to apply, whereas that is not the case under the counterfactual necessarily and under the proposed arrangement there will be ruling panel with a similar responsibility as the Market Surveillance Committee and that as well is a further constraint on the exercise of market power.

MS REBSTOCK: I might just pursue that. If for instance rules don't come forward, just assume rules don't come forward that are pro-competitive, for whatever reason, maybe it doesn't suit anyone in the industry, it is possible. What are the options under the Commerce Act for dealing with a situation like that? How can the Commerce Act address issues such as that?

MR HANSEN: The main point there is that in fact under the new rulebook any person can make a proposal.

MS REBSTOCK: Any person inside or outside?

MR HANSEN: Yes. That is a further development on NZEM where it is restricted to participants.

MS REBSTOCK: Right. What say any person makes a proposed rule change, it comes through, the board decides to let it progress, it's put to a vote, it's turned down, what could be done under the Commerce Act at that point if the rule change was rejected when it was put to a vote?

MR CAYGILL: It's not the Commerce Act that provides the fundamental protection in that event I would submit, but what does stand out about the industry arrangements is that the Minister is certainly able to say hang on a moment, I want you to address this issue. The Commerce Act, where the Commerce Act is relevant is in relation to a rule change that might have been anti-competitive. It would allow an intervention in that regard which might not be available because it wouldn't apply necessarily, under the Crown EGB counterfactual.

MS REBSTOCK: Right. So, in this case there is nothing, except for reliance on the tension that the Minister can create. What is efficient and results in good governance arrangements, given Dr Scott's book on this, that suggests the Minister's role in this instance is an optimal outcome, that we are in the situation, we have a pro-competitive proposal, goes to the votes, it's rejected, and you tell me that we're reliant on the Minister exercising his pressure. Why in this circumstance is this an optimal arrangement, but under the Crown EGB we've just been told that relying on the Minister has all sorts of suboptimal outcomes?

MR KOS: They're entirely different functions. In the case of the proposed arrangement, the Minister's function is in terms of the Act and in terms

of assessing whether there's been due performance against the objectives and outcomes that he or she has set in terms of the GPS. That's the Minister's role there.

It follows a thorough decision-making process in which the Minister would have seen the process, the evaluation that had gone through both the working group stage and the voting stage at the point of rejection. It would be open for any disaffected participant to explain to the Minister precisely what the coalition was they saw, that it resulted in the vote that had come down, why that decision had been made, but it has gone through that process first, whereas in the counterfactual, ultimately the decision ends up first for recommendation by the, GBF the EGB has not recommended it, then the Minister has a decision to make in relation to the proposed rule change.

MS REBSTOCK: I think we established earlier there's no reason to presume that the same process would not have been gone through under an Crown EGB, we don't necessarily know that exactly the same sorts of working parties would not exist.

MR KOS: No, I'm sorry, that one can't go by. We certainly did not establish that. We accept that there is the prospect of a working group process under the Crown EGB. The next stage, the second stage of the vote by participants does not exist. As I said we have - in the counterfactual. So, one of two stages only might exist.

MS REBSTOCK: Well, my understanding in overseas jurisdictions, sometimes you do have votes by industry participants as an indicator to whoever the decision-maker is of where the industry is at. Is that correct or not? That that in fact is also a possibility we don't know that it would or wouldn't happen?

MR KOS: Well, I cannot think of a single submission and all submissions come from an informed perspective to this Commission, which is suggested at that stage. In other words the substantial replication of the counterfactual of the proposed arrangement, in that respect there has been comment on the prospect of working groups, but there seems no position for that second stage in the counterfactual.

MS REBSTOCK: I'm not suggesting that it has been discussed, I'm asking whether there are examples of that actually happening. My understanding, I may be wrong, is that this case that was mentioned earlier, PBS, whatever the initials were, that that is what happened in that case.

MR CAYGILL: But if you're referring to PJM, the Pennsylvanian, New Jersey, Maryland market, as Mr Murray outlined that sits in a very different regulatory framework with great respect.

MS REBSTOCK: I do understand that, but I think coming back to the question, what is the constraint under the proposed arrangements in the circumstances that I put to you and the chairman has indicated that it comes back to the pressure that the Minister may apply, and I appreciate that clarification.

The other issue that I want to ask you about, it would be quite helpful. We've had a lot of discussion about the role of the Market Surveillance Committee I think it would be really useful for the Commission to have you explain to us the role of the Market Surveillance Committee now and what happens to the role that that committee plays under the proposed arrangements. I think it's quite important in terms of - when we - particularly in the context of looking at the condition that you put forward, because we're not in an environment where there is no independent policing of some sort, and so I think we need to be very clear, what's happening now and what's proposed under the arrangement.

MR KOS: We're very happy to take that particular point because one of the strengths of the proposed application as we see it is the effect of continuation of that approach.

CHAIR: Is it proposed that the rulings panel in essence will become a Market Surveillance Committee type structure.

MR KOS: I think Kieran Murray can deal with this but the essential answer is yes to that.

CHAIR: Just before he answers, just before you go on with it. The report of the MSC that's appended to the document covered the situation that arose from the situation last winter and I think was predicated on a complaint made by a retailer against the generator or vice versa. Retailer against the generator. The question of it hadn't been for the particular circumstances in relation to climatic influences last year, do you think that there would have been any other pressures from the market to have the MSC look at that relationship between generators and retailers? It was surrounded as I understood it, in relation to hedging or not being able to purchase hedges. But were there any other issues around the time that might have produced an inquiry by the MSC if it had not been the climatic issue?

MR KOS: That I think probably - sorry, but Mr Alexander is the one that would answer that. That arose from the specific jurisdiction of the MSC to deal with the concept of the undesirable situation, which is a concept as I understand which carries through in the proposed arrangement.

CHAIR: I think I'll ask him when he turns up. I think the critical thing is really was the decisions and views of the MSC influenced particularly by that undesirable event, or does the report basically comment on structural developments in the market? I'll come back to it anyway?

MR KOS: Did you want Mr Murray's comment in relation to the earlier question?

CHAIR: Perhaps Mr Murray.

MR MURRAY: I'd like to make a further response to Ms Rebstock's comments. I think it's, when we think about the potential for pro-competitive rule changes to be blocked, I think the experience of NZEM is also enlightening in a number of regards that we've identified in the study at least 20 pro-competitive rule changes that did proceed through to the vote. The Commission has asked parties to identify what pro-competitive rule changes have been stymied and also what rules could be changed in a way that would be pro-competitive. The list that has come up for a market that has been operating for seven years, the list is quite small. There are seven examples given across all submitters, only four of those relate to issues that are within the rulebook and there are, with the - and there are no examples that I could see in the submissions that pointed to a particular rule that was currently existing, put aside the bid and offer which is now proposed to change, pointing out a rule change that would be pro-competitive.

Which suggests that there are inherent intentions on the parties who are part of the market to search for continued improvement. That doesn't deny the possibility that an anti - pro-competitive rule change may disadvantage a participant in a way that they could stymie it, but that the interests of the parties are reasonably diverse in terms of the technology that they operate, their locations in the country, and it is relatively hard to think of a rule change that would advantage one segment in a way that would significantly disadvantage others and that would be pro-competitive rather than a transfer. I think the point that the Commission's asked for parties to identify that and they haven't been able to come up with the examples is illuminating.

Referring to the MSC and the Rulings Panel, the Rules Panel was intended to take very much the same function as the current Market Surveillance Committee, it's an independent body, it's designed to carry out a surveillance and compliance function and has that special duty to strike down rule changes that conflict with the guiding principles.

MS REBSTOCK: Will it also take the functions from the MARIA side? There is some sort of review panel on the MARIA side as well?

MR MURRAY: That's right currently three members I think of the Market Surveillance Committee do that function for MARIA as a way of efficient rationalisation, so they have been brought together, yes.

MS REBSTOCK: How is it proposed that that panel would be appointed?
MR MURRAY: I believe it's by the board.
MR CAYGILL: By the EGB, by the independent board?
MS REBSTOCK: Right. It is not losing any of the current functions that are currently provided for?
MR WILSON: I think that under the current Market Surveillance Committee actually oversees surveillance and compliance. Under the new model the EGB itself will oversee the monitoring and enforcement function and the role of the rulings panel is to make the decisions. So, it is a slight change from the Market Surveillance Committee.
MR CAYGILL: The breadth of rules over which it has the ultimate supervision is not being narrowed in any way. The rules, may be changing to some extent as compared with the three codes, but the breadth of the Market Surveillance Committee supervisory jurisdiction isn't changed. The question of whether the compliance against the rules, the initial identification and prosecution if you like, should be within the Market Surveillance Committee's jurisdiction as it is now or the Rulings Panel in future, was debated - it was I think a decision that could have gone relatively either way, it was not seen as a - it was seen as important but not a major issue that divided people.

On balance it was decided that given the governance board is independent, unlike the governance arrangements at the moment, then it would be more satisfactory for the Governance Board to have the investigation and prosecutorial function if you like, and the Rulings Panel to have only the judicial function. But that's the change that's being made.

MR MURRAY: Part of the rationale as I understand for that, was a view that as the independent board had an obligation to see that the rules developed in accordance with the guiding principles and other obligations in relation to the functioning of the rules, then it should have some greater influence on the prioritisation of the investigation work.
CHAIR: Can I just add one more to that before we move on. The current Market Surveillance Committee, has it initiated any reviews or inquiries or have they all been as a consequence of requests or approaches from market participants? I suppose Malcolm would --
MR CAYGILL: Yes he would certainly know that.
MS REBSTOCK: I assume that the market or the Rulings Panel is meant to be an independent body?
MR CAYGILL: Absolutely.
MS REBSTOCK: Independent from the industry?
MR CAYGILL: Absolutely, and that is certainly stated in the rules, it's - not just the nature of its functions but the nature of the people who may be appointed to it, I am confident they are specified in the rules.
MS BATES: Who has the appointment power and how does it work?
MR CAYGILL: I think as we said a moment ago.
MS BATES: Sorry.
MR CAYGILL: No, that's fine. The appointment would be done by the governance board. I'm not sure to what extent a formal nomination process is specified, this is not - wasn't seen as appropriately something to which people would be elected, the members don't get to - the members get to vote on the governance board but they don't get to vote on who the --
MS BATES: But they get to decide who's going to be appointed on to the Rules Panel.
MR CAYGILL: The governance board gets to decide that.
MS BATES: How does the market surveillance panel work, who appoints the market surveillance panel?
MR MURRAY: Currently the members of NZEM appoint the members to the Market Surveillance Committee so that is a change.
MR KOS: In answer to Commissioner Bates' question, it's dealt with in part A of the rulebook at page 63, and there's provision there for a Rulings

Panel which we see in 40.1 is appointed by the board. It's five persons, 40.5, characteristics, it's a body whose decisions are likely it be respected by participants, must be independent, multi-disciplinary have the requisite skills and experience to carry out the functions.

MS BATES: Yes, thank you. Just one other thing I wanted to pursue with you, just following on from something I asked you yesterday, was talking about yesterday. The EGB has an obligation to consult with the industry when putting any recommendation up. Now, the Minister does have the power to either accept or reject that recommendation, that's quite clear. But under section 172.Z I think it's not something that the Minister would necessarily do lightly, because first of all he's got a requirement to have regard to the recommendation and also where he departs from the recommendations he's actually got to publish a notice in the gazette, he's got to give his reasons for departing from the recommendation and that that explanation is available to anybody who wants it.

So, there is a degree of transparency when the Minister is rejecting. The other thing is that the Minister would have the power to, under section 172.Z.A, to promote a pro-competitive rule change, would that not be the case? If the Minister considered that that was within the objectives of the Act.

MR KOS: I think the answer to both those questions has to be yes. But as is implicit I think also in the question, there's a great deal more to the process than that very bare account of it.

MS BATES: I'm not suggesting that that's the be all and end all. I'm just saying that there is a requirement which leads to a certain transparency and I just wanted to bring, you know, to highlight that point.

MR KOS: And I'm grateful and we're not disagreeing with that. If we could make for instance what observation in relation to the process though, it still has the vice we identify of the nature of the decision-maker, if the recommendation here is described in the first instance as the first decision by the board, the Crown board, to advance a proposal, then that is informed by consultation rather than direct participation which is our first --

MS BATES: We talked about that yesterday, pros and cons, I understand that.

MR KOS: Associated with that then is a second vice which is a purely economic one in the sense it's the costs associated with the consultative process, as opposed to direct participation is something we also point to, not just in lobbying which we talk about in topic 6 in a moment, but also in relation to the cost associated with a, what is the provision in to a relatively non-expert body or non-directly participatory body.

MS BATES: They're not going to be a non-expert body, surely the EGB will be an expert body.

MR KOS: But our point is a different form of expertise from that associated with the element in the proposed arrangement which has direct participatory voting first and then a potentially similar kind of body over the top of that.

CHAIR: I think we see the difference.

MS BATES: I understand the difference.

MR CURTIN: Just one small question, I apologise for backtracking slightly to publication of bids and offers, but Mr Hansen mentioned that world wide there are efficient competitive markets operating on a blind basis and it got me thinking that we better clarify I think what some of the proposals actually were for publications, publication of bid and offer data. Where the proposals were publication of these data always intended to reveal the party making the offers, or were some of the debate about publication of the prices on a blind basis?

MR HANSEN: I don't have the detail of the proposals in front of me at this time and some of them go back to 1997 before I was even ever involved in an electricity market. But what I would point out is that the information that has been available since establishment in 1996 amounts to the blind

information if you like in the sense that the market publishes an aggregate supply curve which shows the net effect of all the bids and how they stack up. It does not identify who they came from or necessarily even which part of the country. So, any proposal and I'd need to check the fact on the particular proposal, would be taking that further to identify from particular participants. But that would need to be confirmed.

MR MURRAY: Because the nature of the market where offers are submitted at a particular point on the grid and there is typically only one generating unit at that injection point, except if its an embedded generator in a distribution unit, then the revelation of bid and offers which has to be by location to be meaningful does reveal by name, by participant.

MR CURTIN: So it's kind of a moot point. Okay.

MS REBSTOCK: I just have one final question. In some of the examples you've made the point that there was an evidence of delaying for competition reasons. But that the evidence suggests there were genuine concerns with proposals that were being advanced. It made me recall a submission, and I hope I get this right, I may get it wrong, somebody may tell me but I think Mighty River Power suggested that the submission in the draft determination confused issues about institutional inertia, with these issues around walking pro-competitive rule changes, and it does seem a little bit to me a case where yes, and I have some vague recollection that the NZIER might have addressed the same issue. But the issue here is precisely the issues they address, which is not that there aren't genuine concerns.

It may even be that the reasons they might have been not advanced more quickly was not because they were blocking them for competition reasons or delaying, but it simply may be that the competing interests, valid they may be, but an industry is not able to resolve some issues.

I just thought we should come back to those comments made by those parties because it does seem to me some of the instances that you've responded here to our draft, they've suggested that we've got it wrong in the draft and how we were looking at it and that we should look at it in perhaps another frame and I'd like your response to that, because I think what you've addressed thus far only addresses what we've said ourselves in the draft rather than specifically some of the reasoning that has been presented by other parties.

MR MURRAY: You're correct. It was Mighty River Power that made that submission. I think we're bonded in three ways. There are significant changes to the Government structure under the proposed arrangements from what has proceeded that ought to address in some way inertia. First there will now be an independent governing body that will set the priorities for rule changes, it sets the timetables for working groups, that can dismiss and replace a working group that is not delivering to a timetable that it believes is appropriate for the issue. There is the annual performance objectives agreed or negotiated between that independent body and the Minister under the Act which again will at least allow a forum for establishing what the Minister's priorities are and his views about, or her views about how long those events should take to process.

The third point, has gone completely out of my mind.

MR HANSEN: Maybe I could follow-up.

MS REBSTOCK: What a team.

MR HANSEN: I guess the issue I'd like to take up - the third point Mr Murray was pointing to was that any person can clearly put up a proposal as we've emphasised. I think this issue actually goes quite deeply to the heart of our submission and it relates to a comment that was made yesterday that surely these are simple issues, and the facts are that they're not. They're not simple. If you look at, if I draw the commissions attention to annex two of the paper that Kieran and I wrote

where we went through the ten key areas and you look through exactly what happened and by necessity we have to keep that brief.

But when you look at the actual issues and start to think about the pros and cons and the various issues, they are clearly extremely complex issues with a lot of investment and a lot of value behind them, particularly draw - the Commission's particular point to make there is in fact in most, or the majority of these cases, there is a tension between issues of market competition and system security.

That's one of the key issues that brings in the complexity. When we look at those ten areas and six of the ten areas Transpower has had very major concerns. We're not wanting to comment on whether those concerns have merit or not. Our point is they're not simple issues. Transpower has had very substantive concerns and they need to be taken into account.

Under NZEM Transpower has a consent right, which means that if it has - expresses a concern about system security, has a right to refuse for the rule to go ahead. That does not carry through to the new arrangements. In at least two or three of the ten areas, some of those issues were actually not clearly within the jurisdiction of NZEM. They were seen sometimes to be in this jurisdiction of Transpower or split across a number of bodies. One of the advantages of this rulebook is that it pulls the whole lot under one single jurisdiction.

So, that I think is extremely important to take into account in terms of our discussion yesterday about the ability of an independent or a Crown EGB and a Minister to somehow just receive information written in a report and understand the complexity and the trade-offs and the weighting that ought to be given to different issues. Were it that simple, life would be a lot easier for many of us.

But I think any detailed discussion reveals that basic point and in particular the tension between security issues and competition issues. That's why in our submission we have really focused on the incentives around the transmission asset owner and a system operator. We're not saying they are inappropriate incentives, they're genuine incentives. We would expect any transmission asset owner and any system operator around the world to have those sorts of incentives and genuine concerns.

The issue really is how does the institutional structure deals with those incentives. Does it allow or encourage those incentives to override all other considerations or does it actually lead to a balancing? Our submission is that proposed arrangement is better suited to a balancing compared for the counterfactual.

CHAIR: I think the Commission without prejudging at all submissions been made by others can certainly see those points that you've just come to. I guess that's part of the reason why we're here. I'd like to break I think now and I see that Malcolm has just rushed in and might be available after tea for one or two questions. So, we'll start again at say quarter to 11. Thank you.

(Adjournment from 10.35 to 10.50 am)

CHAIR: I think we'll resume. Before moving on to number six on your list which is the transaction compliance and lobbying costs, I think Malcolm Alexander is now available, so there are a couple of points I'd like to start off with him and others may well. We were talking about both the market currently and the role of the Market Surveillance Committee. One point that was in the applicant's submission and discussion of the way the market is worked, the comment was made that there was a vote a couple of years back to take off the possibility of developing an ex-anti market. Has there any work been done or pressure on that at the moment?

MR ALEXANDER: The concept, within the market pricing working group of NZEM which I chair has been looking at over some little while now the issues around the introduction of "real time pricing" and that has, there's effectively no such thing as real time. It's ex-ante or ex-post

effectively. In terms of the working groups deliberations they've been looking at in terms of - what would be the appropriate model going forward and there were debates in the Market Pricing Working Group, which has a particular project manager assigned to this task. What would be the appropriate model?

Generally it was coming down to a five minute ex-ante price or a five minute ex-post. At this time the market is about to proceed to the - the decision has been taken to proceed to a trial of ex-five minute ex-post prices. A rule change is about to go out - has been drafted as of literally now and it's about to go out to the working group for endorsement and will go up to the Rules Committee with targeted implementation in August.

The reason at this time that we didn't proceed with five minute ex-ante was because of security matters around that in terms of what would happen if the demand side reacted and how would you manage the security. So, right now the first step is to go assess ex-post, five minute ex-post, so you'll get five minute price and then there'll also be an average price on the half hour.

CHAIR: Thank you. The second point related to both the, an inquiry the Market Surveillance Committee made last year, that was predicated by the climatic issues in relation to power pricing as I understand it. Now, there are two points really. If the inquiry just happened in relation to market behaviour an issue as against driven by the winter pricing issue, would there have likely to have been any different conclusions about possible oligopoly behaviour? That might be a hard one to answer. Related to it is a question, has the Market Surveillance Committee had anyone queries into market behaviour on its own initiative or have they all been as a consequence of things that have arisen from the market and been a consequence of market participants' complaint or whatever?

MR ALEXANDER: Let me answer by taking the last first I think. The Market Surveillance Committee has a specific obligation and mandate under the NZEM Rules, rule 2.4.2 where it's required to monitor business conduct, it's an explicit part of its mandate. The rule is to actually monitor the conduct of each market participants' business and the performance of each business provider. It is not a reactive body, it has a pro-active mandate as well, which it is quite active in pursuing.

Within the market administrator there is a team known as the "surveillance and compliance team", five or six of them, and they work effectively directly under the auspices and mandate and direction of the Market Surveillance Committee and together they target areas, so they're not simply reactive and for example recently they looked into the area of reconciliation in terms of what was going on there, were the market participants in compliance with the rules and so on and so forth.

That happens all the time. So, they have a programme, they are required under the rules to also maintain a work programme. So, that is a standard element of their task. Obviously they also respond to allegations of rule breaches and so on and so forth.

In terms of the specific ruling of the Market Surveillance Committee last year, I don't think it's quite correct to say it was driven by climatic conditions. What it was driven by was price, and --

CHAIR: Yeah, but whether the climatic drove the price is a moot point I guess.

MR ALEXANDER: There was also related issues around prudential security. In fact, sort of contemporaneous at that time one market participant was ultimately found to be in breach for not having met a call for security issue by the clearing manager.

CHAIR: You mean prudential security?

MR ALEXANDER: Prudential security. As you would expect as the price rose over time. Under the rules the clearing manager has a responsibility to monitor exposure of purchasing market class participants and periodically, dependent on that exposure, may make calls for further

security, and in that case one market participant missed his call by a day and was ultimately found to be in breach for that. So that was happening at that time. So, the Market Surveillance Committee in my view was appraised of what was going on. They also receive in addition to reports from the surveillance compliance team, I give the Market Surveillance Committee a report once a month as do all service providers. But I present to them in person, and have the opportunity to discuss with them issues of either general interest in the market or the broader regulatory environment, or issues that they wish to pursue with me.

It is a regular part of that report that we report price movements, that we report hydrology, so on and so forth. So, they were well aware of what was going on, and were particularly concerned, and as part of their monitoring and proactive function, were particularly concerned that the market administrator and the clearing manager were keeping a keen eye on prudential exposure.

The actual inquiry though that resulted in that determination was initiated by a market participant who alleged that prices in the market effectively resulted in an undesirable situation.

CHAIR: Thank you. If that comes to the end of your item 5, sorry --

MS BATES: Just Mr Alexander, just do you think that the Rulings Panel is going to fulfill the same sort of function as the Market Surveillance Committee?

MR ALEXANDER: In part yes, but remember under NZEM the governance body of NZEM is the Rules Committee in terms of oversight of day to day governance and the rule making process which is comprised of representatives of market participants and service providers so the Market Surveillance Committee, was the independent body in the market, in fact is a governance body in its own right under NZEM rules.

Under the new rulebook the EGB is independent and therefore it has been given effectively the surveillance function and I suppose the quasi-judicial function lies with the Ruling Panel so it's re-apportionment of responsibility.

MS BATES: Between the two?

MR ALEXANDER: Between the EGB and the Rulings Panel, but driven by the fact that the EGB is independent, in contrast to the position of NZEM.

CHAIR: I think as a comment, to be fair to the MSC, even they've been appointed by NZEM, they've certainly been independent.

MR ALEXANDER: As being a recipient of many fines I can attest to that.

MS BATES: In your opinion will the proposed arrangement operate as well?

MR ALEXANDER: In similar fashion do you mean?

MS BATES: Yes.

MR ALEXANDER: In my view, yes. Well, I have no reason to suspect that it will not.

MS BATES: Thank you.

CHAIR: Thank you. Thanks Mr Alexander. All right, well, if you agree we'll move on to number six which is transaction compliance and lobbying costs which was covered in the draft determination and please Mr Kos.

MR KOS: Thank you Mr Chairman. Just in transition between the two topics I note that in relation to topic five we have looked in depth at the primary argument about whether there is going to be a propensity under the proposed arrangement for strike down or delay of pro-competitive rules. The Commission will remember that our core argument though was - not only was that detriment not there but there was a benefit in terms of the counterfactual.

We haven't addressed that in fact at all in discussion, and I didn't want to move from that topic if there was any concerns the Commission had in relation to that particular issue because this is really the time to deal with it, but if there aren't any concerns or you don't want to hear us further on that point we're very happy move on to six.

MR CURTIN: You mentioned that in your assessment of the strike down risk that there's a net benefit. Just looking at the updated assessment from ECG, I think they dispute our detriment but don't have a positive benefit there?

MR KOS: Sorry that's right. I was weighing the two elements. The net benefit comes from the fact that the counterfactual has a greater detriment than the perceived detriment in relation to the proposed arrangement, even if the Commission and submitters in terms of the draft determination are right on the perceived detriment on strike down.

MR HANSEN: Just to be clear about that, it's a separate line item. It comes under strike down by transmission asset operators and system operator. So, we were balancing those two.

MR CURTIN: Okay thank you I see that.

MR KOS: Sorry I didn't want to hold things up.

CHAIR: That's fine. It's over to you again please.

MR KOS: We can deal with topic six from our perspective reasonably quickly, both in terms of the draft determination and the applicant's analysis. The perceived net - the perceived benefits from - in relation to transaction compliance and lobbying costs between the two models is assessed at 6 to 12 million. There is no difference between the draft determination and the applicant on that particular point.

I think I can go straight to paragraph 6.7 and quickly touch on the rationale for that assessment. The - we've addressed a lot of these issues already. In terms of the counterfactual at B) we note that the Minister is the key decision-maker, as opposed to the proposed arrangement of voting members of the key decision makers. Again there'll be inter se lobbying between voting members the industry EGB has a primarily process management role.

So, the perception we advance is that as between the two models there will be a greater extent of lobbying particularly of the Minister and there's a net cost as between the two models in that respect, or net saving in favour of the proposed arrangement.

The point we make at E) is a significant difference is that the industry voting parties would have less reason to engage in ministerial or Governmental lobbying. Countering that in F, the Crown EGB would have a greater need than the industry EGB for information. It's a slightly different issue isn't it? In one sense one is lobbying, the other aspect is the consultative requirement, the acquisition of information which is a matter that we touched on in discussion before.

At G and H we make the point that the industry EBG creates a bridge between market participants and the political market in a way that's more likely in our submission to be successful in solving tensions between industry and political interests, the proposed arrangement we say establishes an independent forum based around a rule change process. So, we submit that the opportunity for potential returns from lobbying are less, under the proposed arrangement, than the counterfactual.

On transactional and compliance costs we submit two key points. First that poorer quality rules in our submission would occur over time, under the counterfactual, and that would lead to higher compliance costs and a greater level of non-compliance, and we submit secondly that current contractual methods of enforcement are effective and will continue to be so under the proposed arrangement.

We've heard something of that this morning in terms of the work of the MSC. We expanded that slightly, that point, in section B, and we say that we're not clear why the NZIER who provide a report supporting Transpower consider the compliance team and Rulings Panel to be poorly adapted to enforcement needs. In any event we note the counterfactual would appear to envisage similar bodies operating presumably at similar costs, so there seems to be a neutrality between models there.

Nor are we aware of any evidence suggesting that similar

enforcement process adopted by NZEM have proved ineffective. Mr Alexander from his last comment certainly sounds as if he thinks it's been more than effective in relation him. In fact, the key point I suppose there is the NZEM model has been adopted both in MARIA and in MACQS. So, there's been a take up of the model rather than a rejection of it. We've noted in 3 the extent of both the costs and also the number of fines, value of about $850,000 per annum, and notably that the NZEM has never taken a member to court for non-payment of fines.

So, in our submission, that lends weight to the second of the two points we make in A. Certainly Malcolm can respond if there are any specific questions on that last point. That's our submission on that point Mr Chairman.

CHAIR: Thank you Mr Kos.

MS REBSTOCK: Can I just ask one quick question. Is there any appeal to the Market Surveillance Committee's rulings?

MR ALEXANDER: Under the NZEM rules there is a right to go to an appeal board. That has been exercised from time-to-time.

MS REBSTOCK: Who's the appeal board?

MR ALEXANDER: An ad hoc body which is appointed by the market administrator from time-to-time. An example, we in recent times have used the chair of the appeal board, David Tompkins.

MS REBSTOCK: What happens under the proposed arrangements?

MR KOS: There's no appeal beyond the Rulings Panel provided for.

MS REBSTOCK: Would it be possible to take legal proceedings outside as a result of there being no --

MR KOS: Yes.

MS REBSTOCK: Is that a possibility only now is that right?

MR KOS: Yes.

MS REBSTOCK: That hasn't happened?

MR KOS: They're both contractual models.

MS REBSTOCK: Right. But there's been no legal proceedings taken in response to a ruling.

MR ALEXANDER: In response to a ruling no, but I do recall, if memory serves me right, there's been at least one occasion where some party attempted to have something litigated outside but I believe the Court took the view, exhaust first the remedies within the contract.

CHAIR: Can you just give us a note on that at some point?

MR CAYGILL: There's certainly no attempt within the rulebook in front of you to oust any civil jurisdiction that might exist.

MS REBSTOCK: Maybe this is a question to lawyers on the team, but does the removal of the appeal process increase the likelihood of litigation in your view?

MR CAYGILL: Can I speak, not as a lawyer, but as somebody involved in trying to supervise the design process. Again, the question of whether we should retain a second tier of appeal was debated at some length. There was no - that debate wasn't as between one class of participants or another, it was felt given the independence of the governance board, as compared to the existing governance bodies, that that altered the balance in a way which perhaps meant that we would not need an appeal board at the outset. I would regard the issue as very much still open and if experience suggested that there was value, for example because people were resorting to outside civil jurisdiction, then that's exactly the kind of evolution one would expect.

There's no reason to think one group of participants would not want that internal appeal right. It was taken out simply because it was thought on balance we probably wouldn't need it, let's see how the rules evolved.

MS REBSTOCK: I probably should recall this, but I can't so I'll ask you. The legislation with respect to a Crown EGB, what are the appeal rights in that. Is it clear that they're --

MR CAYGILL: There is no mechanism spelled out for appeals against --
MS REBSTOCK: If I'm correct in that case, if they haven't ruled out appeal on substantive issues then the appeal right to the Court is maintained, is that right.
MR CAYGILL: I would not describe it as an appeal right.
MS REBSTOCK: Right. The ability to take both - to take - would that be there?
MR CAYGILL: Yes, judicial review, but it is a very different process.
MS REBSTOCK: I'm asking beyond judicial review, would there be something beyond judicial review, under the Crown EGB?
MR CAYGILL: No. There's no equivalent to an appeal right as such in the Crown model. It's a regulatory decision.
CHAIR: So it's a normal action against the Minister's decision is that what you're saying?
MR CAYGILL: Or against the Crown EGB.
MR KOS: That must be right in relation to the Crown EGB model. IN relation to the operational structure of the rules as to whether there's an appeal right or not, I suspect the position is one of neutrality between counterfactual and proposed arrangement, because we don't know whether the Crown EGB model would have a rulings panel appeal right at all. So, on that question of the comparison, I think we have neutrality.
MS REBSTOCK: Yes, that's really what I was driving towards. I appreciate that. That's fine. If you're quite clear on that, that's fine. If there's anything you want to add of course you can come back to us.
MS BATES: Could I just take up a matter with you on the question of the comparative costs under the two arrangements and just one matter that occurs to me that you may have touched on and apologise if I've missed it. But under the proposal, and after the setting of objectives and outcomes, of course there's an obligation to report under the legislation and then that report is examined by the Auditor General and by the Commission for the Environment I think. I just wonder whether - there would necessarily be a cost in evaluating and monitoring performance. So, I'm just wondering to what extent those costs have been taken into account?
MR KOS: In terms of the two models, again we have neutrality because that same process applies to the Crown EGB. It too has to report.
MS BATES: But it's not quite the same report as required under the legislation is there?
MR KOS: The only difference is in relation to the agreement of performance standards. That's the quid pro quo for a self regulatory model.
MR CAYGILL: The process is not - is obvious in a formal sense. It's not spelled out, but I acknowledge that. As a Crown entity I would assume there is every prospect that the controller and Auditor General would be invited by Parliament to be auditing and reporting and if the Parliamentary Commissioner for the Environment thought fit, that is to say thought that the activities of this entity were of relevance to environmental issues, then I would expect that the Parliamentary Commissioner would take that initiative.
MR KOS: Can I --
MS BATES: It has a statutory obligation to do so, so I'm just saying there is a cost involved with those obligations which are carried out?
MR KOS: Absolutely. Our point is that it's neutral between the two because, as you have quite rightly identified the Auditor General and the PCE's functions apply to both models.
MS BATES: Do they?
MR KOS: Yes, they do. 172.Z.O, one, the auditor general must examine the annual report provided under 172.Z.M, and that is an EGO's report and that includes both the Crown EGB --
MS BATES: We start at the annual - the agreement of annual performance standards?
MR KOS: With respect we don't. The single point of difference between the two

models is this, that the private model, the non-Crown EGB must agree performance standards with the Minister. That is the sole difference. Both the Minister and the Auditor General and the PCE will look at the annual report and if we look at 172.Z.M Commissioner, at 172.Z.M.2 you'll see the annual report has to contain an assessment of the performance of the organisation against the GPS objectives and outcomes and in the case of the non-Crown EGB against the performance standards. It's that report in 172.Z.M that's reviewed.

MS BATES: Sorry, I'm at 172.Z.M, unfortunately my copy of the Act has got a bit missing down one side so just bear with me for a minute.

MR KOS: It can make all the difference.

MS BATES: It can make all the difference and I am getting a proper one. So you're talking about the GPS outcomes in 172.Z.M subsection 2?

MR KOS: Yes. So, the annual report is enlarged in the case of the private, or the self-governing body.

MS BATES: I see what you mean. So, they then - they've got a further obligation to report to see if the performance standards and outcomes.

MR KOS: That's right, but the core document, whether it's a slimmer Crown one, or the enlarged self regulatory one, then goes to the house to the Auditor General and the PCE.

MS BATES: I see. Thank you for correcting me on that. There may be some slight difference in costs of course.

MR KOS: Yes.

MR CAYGILL: With respect, Commissioner if you go back to 172.Z.I to see that the whole of the accountability provisions applies to the EGB if it's established and then in anyone else that might be an EGO.

MS BATES: I'm quite clear on it now. It's just the extra bit in making sure that the outcomes and objectives are complied with.

CHAIR: Thanks Mr Caygill. That brings us down to item 7 I think in your document. The only comment I'd make I think on the submission on who's to be lobbied, fortunately this Commission doesn't appear to be listed there so that's something to be thankful for anyway.

MR KOS: I'll ask Dr Palmer to deal with this one Mr Chairman.

CHAIR: Item 7, thank you Dr Palmer.

MR PALMER: Topics 7 and 8 deal with transmission. Part F, the rulebook is new relative to the existing industry codes, and address historical impediments to contractual solutions for transmission investments. In the draft determination, the Commission stated that there was a greater likelihood for over-investment, a propensity for over-investment in the counterfactual, the Crown EGB for two reasons. First the Crown EGB and the Minister would be politically accountable for security failures in the transmission network, and secondly they would not bear the costs of any involvement which improved security.

This creates, as the Commission found in its draft determination a natural propensity towards over-investment, over caution in terms of security. The benefit assessed by the Commission of the proposed arrangement relative to the counterfactual was $10m to $20m, and the applicant agrees with that assessment.

In relation to under-investment the draft determination found that - identified a risk of under-investment in the proposed arrangement, resulting from the fact that distributors who the Commission considered would hold the majority of voting rights would only have week incentives to improve investments in so far as they related to removing constraints which creates segmentation in the market.

The applicant has submitted that that understanding that resulting from misinterpretation of the rules as to how voting rights are allocated and that's addressed in our submissions and I'll talk on that shortly. The detriment associated with that risk of under-investment was quantified at $29m to $54m. In essence the applicant agrees with the Commission in relation to over-investment, but disagrees in relation to

under-investment. In our view there is no detriment to be attributed to under-investment.

The following parties: Contact, Genesis, Meridian, Mighty River Power, Trust Power, United Networks and WEL Networks all broadly agree with those two elements of the applicant's submission.

Moving to para 7.7, investments in the grid may benefit participants either by removing transmission constraints which restrict the ability of generators to compete or --

MS REBSTOCK: Sorry which paragraph?

MR PALMER: 7.7.A.

CHAIR: Just before you move on, I'm sorry to break your train of thought. As you say, a number of people have submitted that under-investment is likely under the arrangement and that there's been under-investment in the grid in recent years. Has the applicant got a view on that particular point?

MR PALMER: It seems I think well understood in the industry that there has been under-investment and part F is a response to that perceived under-investment.

MR CURTIN: Just following up on that if I could, could I just have your understanding of what investment, transmission investment gets undertaken at the moment and on what criterion?

MR MURRAY: I think it is a question that's better addressed to Transpower when they submit. My understanding is that Transpower will invest to maintain security where they believe that the security of the transmission system is threatened, but don't invest to reduce nodal price differences per se and that they seek primarily to have contracts with their customers that will underwrite investments that they make.

CHAIR: All right, we'll pick that up again with Transpower. Dr Palmer.

MR PALMER: Returning to 7.7 A, from an efficiency perspective investments in the grid should be made when they result in a net public benefit, but given the benefits of investment and transmission maybe shared a number of different participants, grid investments give rise to problems of collective decision-making, in that a party might feel that it can benefit without paying for an investment, it may hold out in the expectation that the investment will be made regardless and so it has some expectation of sharing the benefit without paying the costs, that creates free riding and hold out problems.

There have been other historical problems which its believed have restricted the ability of contract to adequately deal with transmission investment because of ambiguities over, over service definitions and a lack of price signals going back to the parties.

Part F addresses the risk of free riding and hold out by reducing ambiguity over current services and prices. This is dealt with in section one and three of part F and by putting in place a framework under which a transmission provider may form a coalition of parties who will benefit from a change in service or a new service. That's dealt with in section 2. A full description of the way part F works is contained in pages 39 to 41 of the original application.

In relation to section 2 the voting parties are those transmission purchasers who would pay for the service under the politically confirmed pricing methodology and votes are allocated to proportion to the amount each would pay. If an investment attracts a 75 percent majority of that pool of voting parties then all of the parties in that pool are bound.

Two notes about the way that process works. First is that investments required to maintain existing service levels don't need to go through that process. They're just part of the transmission provider's obligation to meet its existing contractual arrangements. Secondly, paragraph D, participants can also agree to investment outside the process. Part F, section 2 isn't meant to be exclusive or exhaustive of ways investments can be agreed. It simply creates a process which is an

attempt to overcome the problem of free riding and hold out. It is therefore envisaged that section 2 will be used generally for large new investments, where there is some disagreement over whether or not the investment should proceed.

Examples include the possibilities of enhancing transmission services for the Auckland region, or reducing transmission constraints in the Bay of Plenty area.

I'd ask Kieran Murray to talk a little bit more about the way the process will work to form coalitions in practice.

MR MURRAY: As Dr Palmer outlined, a transmission investment which has a net public benefit, there must by definition be a possible or potential coalition of parties that would support that investment. That is there are a - there are transmission customers that would benefit from the investment. The section 2 process is intended to provide a mechanism by which those parties can be brought together and by which, where they come to an agreement and there is a threshold of a vote of 75 percent, then that investment is, all parties are obliged to contribute and support that investment.

The proposal for an investment might be made by an incumbent provider of transmission services, Transpower, a provider of an alternative transmission service, for example some distribution companies maintain fairly significant distribution assets and might potentially provide transmission, and obviously an example is the potential for vector to provide a transmission substitute for upgrades to servicing the Auckland area using their tunnel.

The proposals might also be put by a substitute for transmission, a generator locating at a particular point on the grid in order to reduce the need for a transmission enhancement. All of those parties may use the mechanism in section 2.

MR PALMER: That process is summarised at paragraph H or the reasons why the applicant believes that investment will be efficient under part F, that there is - for the kinds of investments that are efficient to occur there will be a net benefit and therefore by definition a potential coalition to support it.

Roman numeral 2, given that investments which go through the section F process will be high value process, although there'll be a transaction cost in the formation of the coalition, they're large investments so the transaction costs should be small relative to the value of the investment. Thirdly, coalitions are not pre-determined in any sense.

That is, there's no reason to expect that distributors will be part of the coalition or have the majority of votes in the coalition, particularly if those distributors can't capture the benefits of the investment. So for those reasons the applicant believes that section 2 of part F creates the right process for allowing coalitions to be formed to overcome the hold out, free ride problem and for efficient investment to occur.

MS REBSTOCK: You're going to come on to the 75 percent threshold, are you going to?

MR PALMER: Yes.

MS REBSTOCK: I'll hold off. Can you tell me where you are and what page. I'm sorry I'm trying to follow?

MR PALMER: Page 36 H.

CHAIR: Just before you resume, this same process presumably would be available whereas you I think Kieran Murray said, if there was a generating facility being built close to a load, one assumes this process would also be available for Transpower to take some capacity out of the grid in an area like that. I mean this all talks about new investment but one of the issues I'm sure Transpower will cover with us, is the need to maintain the current capacity of the grid which can relate at least

regionally to certainly changes in where supply is coming from.

MR MURRAY: That's correct. If I understood the question, the mechanism would be available for Transpower to agree with its customers a reduction in service.

CHAIR: Yes. That can quite often be a significant issue as well as I understand it.

MR MURRAY: Certainly can. That would particularly occur - number of instances where that occur, where there is redundancy and proposal to reduce that, or where, as you outlined Mr Chairman, a proposal to build a generation unit would create redundancy, then Transpower customers are interested in finding the most efficient solution and that might involve a reduction in service from Transpower combined with an increase in service from a substitute.

CHAIR: Thank you.

MR PALMER: Before moving to paragraph I at the bottom of page 36, the - to reiterate what was found in the draft determination. The Commission held there that there would be a risk that this process wouldn't perform properly and that some efficient investments would not occur, but that under the counterfactual the Crown EGB would have - it would be an investor of last resort and would ensure that such investments did occur. So, just to be clear, the applicant's submission is that section 2 of part F creates an appropriate process and that there is no such risk of under-investment.

Then turning to Transpower's submissions, which we refer to in paragraph I at the bottom of page 36, in paragraph 10.3 of Transpower's submissions it sets out a number of reasons why it believes that under-investment will occur and the absence of having the Crown EGB as a final decision-maker taking as a group paragraphs A, E, F and G of paragraph 10 three in Transpower's submissions, these paragraphs Transpower essentially submits that the industry participants will have different ideas as to what counts as a benefit, that they may not include all relevant costs in assessing an investment decision, that they may focus on short-term returns, and that they may not be fully accountable for a lack of investment.

The applicant submits that this view is not correct and that industry participants are in the best position and have the best knowledge base, including knowledge of non-transmission alternatives to an investment to make such decisions. Since the participants will face the costs and benefits of investment decisions they are in the best position to evaluate whether an investment is cost justified. To the contrary, as we've discussed in detail yesterday afternoon and this morning, the Crown EGB as a decision-maker will have a poor knowledge base. Also will be biased in favour of over-investment for the reason we talked about before, that they will be politically accountable for security failures but not bear the cost of investment, and it is submitted that the evidence referred to yesterday in terms of the world bank study, the treasury report also reference to Dr Graeme Scott's book, show that there is good reason to believe that the Crown EGB and the Minister will be a poor decision-maker in regard to large investments.

MS REBSTOCK: Can I just ask you a point of clarification. I'm just trying to understand this. In this particular arena, the actual board has some final decision-making rights, some override potentially?

MR MURRAY: That is correct. There is a provision in section 2 where the board could override a decision to - a vote to proceed with investment or not proceed to investment. That override is constrained or limited to circumstances where distribution companies hold more than 25 percent of the vote, and that those distribution companies that were voting did not follow some process of engagement with their customers before determining their vote on the major investment.

The background behind that was a concern by the TWG that a

distribution company, perhaps subject to greater return regulation or some form of regulation that is yet finally to be determined by the Commission, may have incentives that are not aligned with its interests of its customers and therefore where those distribution companies have not consulted with their customers on the investment, then that decision will be subject potentially to an override. If there are further constraints in relation to being forced to invest, the vote would need to have been put on two occasions with one year apart and the EGB needs to be convinced that in overriding that decision and forcing the investment that would give rise to a net public benefit.

CHAIR: Doctor Murray - sorry, Doctor Palmer.

MR PALMER: Second paragraph on page 37, Transpower refers to the Auckland CBD cable failure as an example of a reputational cost which the industry participants won't take into account when they're determining investment decisions under the proposed arrangement. In fact, the report of the ministerial inquiry into the Auckland power supply failure emphasised the importance of market disciplines and commercial contracts to make risks and risk allocation visible. The Crown EGB would undermine this approach by shifting decision responsibility, ultimate decision responsibility to a third party.

The override in the Crown EGB situation is much broader than the possible industry EGB override that Kieran Murray referred to. In paragraph B of Transpower's submissions in paragraph 103, Transpower submits that the 75 percent threshold is very high. Transpower also however appears to submit that the threshold is too low and 100 percent support should be required to amend existing investments.

That's an implication from the joint Comalco Meridian or an apparent implication from the Comalco, Meridian and Transpower letter. We submit that the 75 percent threshold strikes an appropriate balance between removing the hold out risk on one hand, but also recognising that participants should not be lightly required to fund an investment which they've voted against. If there's a minority of ten percent then they have to pay for the investment as well even though they've voted against it.

75 isn't a magical number. There's no answer to the question why not 74, why not 76? But 75 percent is a number that's used in analogous situations such as decisions in company law which require a special majority which override the rights of the existing shareholders.

In relation to paragraph C of Transpower's submission, this is essentially a submission as to lack of incentives of line companies. The applicant repeats its submission that there is no reason to believe that line companies will dominate the voting, or to believe they will not be probably incentivised within the provision specified in the independent EGB rulebook.

In relation to paragraph D of the Transpower submission, this relates to a particular free ride risk, where a retailer for example supports - if they support an investment which reduces nodal prices which then encourages further entry into that region it could result in the nodal prices bouncing back up again.

That's the issue which is in fact addressed by financial transmission rights. Financial transmission rights protect transmission investors from having their investments undermined if other users increase load following investment which reduces nodal price. FTR's provide transmission rentals to the investor as compensation if it faces higher energy prices if other users increase load following the investment. So that concern of Transpower is taken care of by that mechanism.

Those points therefore address the points raised in paragraph 103 of the Transpower submission. There is another submission which Transpower makes at paragraph 14 and is also made by Professor Hogan at

page 5, in his report. That submission is that purchasers who are not bound by the rulebook, that is participants who stay outside the rulebook, will be able to free ride on investments. In response to that the applicant submits that there is no reason to question the Commission's conclusion in its draft determination that there will be few, if any, non-members.

The mechanisms which achieve this, and you will know they often go under the name quantum meruit. It's in fact a greater set of mechanisms, we discuss at section 9 below. I'll leave those for now and we will talk further about the mechanism for ensuring participants become part of the rulebook. Secondly, Transpower will still have contractual or other rights against non-members who receive transmission services. A non-member who receives a transmission service may still be in a contractual relationship with Transpower, or if not Transpower will have its rights of quantum meruit against it.

If Transpower is taking such an action, in fact it will be greatly assisted by part F as part F results in a price being determined by - through a process here. So, there will be - it will be much easier for Transpower to claim the price it wants to charge through a quantum meruit is fair and reasonable.

Page 38, the counterfactual does not deliver certainty either. That is, a determined free rider will still be able to challenge the payment mechanism under the counterfactual through judicial review or challenging the regulation which requires payment as being ultra vires.

Fourthly, Transpower uses a Kiwi Cogen example at paragraph 15. Here Transpower's comments relate to the current arrangements, not to those proposed by the applicant. The proposed arrangements will strengthen considerably the ability for the industry to enforce agreed minimum standards.

CHAIR: That point's made pretty strongly by Transpower isn't it, it was a quality issue I think, that's made very strongly by Transpower as a reason against these arrangements. They obviously don't see it being solved by these arrangements.

MR PALMER: Their discussion about it isn't in terms of how it would work under the new arrangement, it's in terms of what has happened historically, it doesn't address part F.

CHAIR: I'll read it again, thank you.

MR PALMER: Professor Hogan argues that Transpower's special mandate ensures that transmission investment will be made despite free riding. Although Transpower can be expected to have good information on how to deliver a particular transmission service, it will have considerably less information on the demand by individual customers. The proposed arrangement provides a means for services to be agreed that reflect the demands ultimately of customers. On the other hand the Crown EGB risk services being forced on customers at the urging of the supplier.

Those are our submissions on the risk of under-investment under the proposed arrangement. Unless there are any questions I'll turn to over-investment under the counterfactual.

MR CURTIN: I'd just like to pick up on one if I could. You've referred to Transpower's arguments in paragraph 103, but slightly earlier in paragraph 101, I'm going to ask Transpower about this also. Transpower is pointing to some real life examples where in their view there was a clear necessity for investment, clear agreement that investment was required to relieve some of the constraints that arose during the winter 2001 events, a clear agreement from everybody that Auckland needed some fixing. But nobody would actually step up and pay for it, even where everyone was agreed that this was needed. So, --

MR CAYGILL: That's why we need part F.

MR CURTIN: I suppose their argument is they're big and ugly enough to make their own argument, but their argument would be, will anything really

change?

MR CAYGILL: Part F provides a mechanism that enables the parties to get over that vacuum. It's the answer to the problem that has been around for a long time, was certainly identified by the inquiry, is identified or recognised in the Government policy statement. One can debate whether the fine detail of part F has exactly got things right. After all we - it's wholly novel, we haven't been able to road test it until we can - until we've got an authorised set of rules and so on. But to take an existing example and say well, the industry won't agree at the moment and why would they agree in future, the answer is now there is no mechanism that can force somebody unwillingly into an arrangement, if they're all agreed and prepared to put their hand up there is no problem.

Transpower gives valid examples where not everybody has been prepared to do that. That's why we need a framework, and that is what part F provides. There's no - I don't believe that those examples demonstrate part F will fail. What they demonstrate is why we need a mechanism like part F.

CHAIR: I think both under the proposal and the counterfactual is an acknowledgment of a need for a change in process.

MR CAYGILL: No question of that. It's unclear whether the Crown EGB would use a mechanism like this, as distinct from simply accepting a submission that certain investment is required and therefore people must be ordered to pay for it.

CHAIR: All I'm saying is there seems to be acknowledgment that the current system does not provide that mechanism to develop an investment, that's the point.

MR CAYGILL: Absolutely. The applicant doesn't disagree with Transpower over that. The applicant says precisely there's a need and here's our answer.

MS REBSTOCK: It would be helpful if you could tell us what supports the conclusion that a 75 percent threshold would overcome the current problems. I mean I understand when you say you haven't been able to road test this, but have you done a series of scenarios that would suggest that this is the right threshold and that it addresses the problem.

MR CAYGILL: I think the answer is best to come from Kieran Murray. The transport working group certainly considered a number of detailed approaches and a number of working examples designed to test whether these mechanisms were robust and appropriate.

MR MURRAY: Those worked examples were done. I don't think they are sufficient to answer categorically, is a 75 percent threshold the correct one or as James said should it be 74 or 76. What we can say is 50 percent seems too low.

MS REBSTOCK: Why is that?

MR MURRAY: Given the consequences that can occur. What it says is that on a major investment, a 50 percent threshold would say if 51 percent of those supported it, 49 percent of those who argue that the investment is not the correct investment, does not provide benefits to them, would be required to support the proposal, would suggest that the proposal itself could be improved upon. That there is a more efficient enhancing outcome than that. There is no exact science around that 75 percent figure. As James said some scenarios were done, whether they are --

MS REBSTOCK: How did you weigh up the risk of setting it too high and having under-investment with the risk of setting it too low and - what - how did you think about that?

MR MURRAY: The process that we've gone through in the TWG was to try and describe that risk as best that we could for the group to go through scenarios, for that 75 percent threshold figure to be subject to two consultation rounds with the industry, and the response has been that that seems right.

MS REBSTOCK: Have those scenarios been provided to the Commission?

MR MURRAY: Some of - two of three worked examples were handed to the

Commission. We can get them updated and - well we can do a further version.

MS REBSTOCK: Provide us with a full set of what supported that 75 percent that would be useful. What about this issue that's been raised by Transpower about the implications of non-membership.

MR PALMER: That's the free ride point which is addressed in paragraph J for those reasons, that there's - there is no reason to think there will be, well there's no reason to think that anyone will be outside the rulebook and if there are, there's no reason to think that it will be major players or more than one or two players. We'll deal with that issue later on.

MS REBSTOCK: When we come - right.

MR PALMER: But there are further responses to that. The first is that Transpower, if there's someone outside the rulebook who's benefitting from the service Transpower can take an quantum meruit action against them and the rulebook will help us in establishing what price a judge should find against that party, and therefore the problems which may exist at the moment for Transpower taking that action will be eased.

MS REBSTOCK: But the comparator is with the counterfactual, right? How does it compare with what would happen in the counterfactual?

MR PALMER: Under the counterfactual there presumably would be power through regulation for Transpower to recover those changes. The point there is that there is no certainty of recovery of payment under the counterfactual either. If there's a person who is so certain they want to stay outside the rulebook they want to pick a fight, there's no reason to think they won't pick a fight against paying under the regulation either through judicial review or challenging the regulation as ultra-vires or some other such mechanism.

MS REBSTOCK: Are you going to come to the issue of the conditions that Meridian has put forth with respect to part F? They've suggested some conditions be applied.

MR KOS: I think we anticipated coming to that in reply because I think we'd like to hear more on the rationale for it.

MS REBSTOCK: In reply, okay. That's fine, I just wanted to make sure you had the opportunity to respond to that point. I just make the comment that normally in the reply we don't pursue questions, so it will be up to you to make sure you raise everything that might need to be raised. Just one last question, I can't let it go, the reference to the ministerial inquiry, the Auckland power crisis. I'm not sure I understood the relevance of the comparison of Mercury's commercial decisions within its own network with this circumstance, where we're talking about the incentives between different parties who can free ride, and I'd just like you to clarify that please.

MR CAYGILL: I think we were responding to the suggestion of Transpower that it was relevant, it's not our submission that it's especially relevant, but --

MS REBSTOCK: I understood that, but I didn't understood your explanation of why it wasn't. Sorry I wasn't clear on that.

MR MURRAY: One of the recommendations from the inquiry was that Mercury should increase the specification in its contracts with its customers around the services that it provides so that its customers and Mercury can have a better understanding of the risks that are entailed in those services, and therefore the information and incentive to manage those risks.

MS BATES: You mean by the customers insuring?

MR MURRAY: Yes, insuring or putting in alternatives or understanding what risks they're exposed to on the current service level.

MS BATES: So that's sort of ensuring that that - they know what the risks are that are not necessarily going to be covered by Mercury's performance?

MR MURRAY: That's my understanding of one level.

CHAIR: Or presumably if they're not, taking some other track on it.

MR CAYGILL: They could be covered by Mercury's performance if somebody is paying. This is an area where there is potentially - the question is how does one find a reasonable balance given that there's always a level of risk that will be out there, which you could conceivably cover by more investment if there's somebody prepared to put their hand up and pay for it.

MS BATES: It's a balance of risk allocation between the provider and the consumer?

MR CAYGILL: Yes.

CHAIR: That comes back to points I'm sure you've faced in earlier incarnations about you can make anything here if you pay for it.

MR MURRAY: Commissioner Rebstock the point I wanted to make was that the analogy with part F to the extent that there is, is that section 1 of part F concentrates on defining more clearly what it is that Transpower currently provides in its services, and having those service descriptions incorporated into its contracts with its customers, so then both Transpower and its customers can evaluate what are the risks and the services that are provided or catered for by those contracts and hence the point I'm coming to is then better evaluate whether they want more or less transmission services. So, that those decisions aren't made by an independent third party who is not exposed to either the service or the risk.

MR CAYGILL: The applicant is not taking any position as to what the level of risk should be or who should bear it.

MS BATES: I understand that.

MR PALMER: The short point is the recommendation referred to from the Mercury inquiry is very consistent with the part F approach.

CHAIR: Okay, anything else?

MS REBSTOCK: Sorry, I said I had only one more question, there is one.

MR PALMER: One question with two parts.

MS REBSTOCK: I just recall a question that the staff had raised and that is with respect to - might be able to accept that a Crown EGB might face high transaction costs in trying to obtain information from consumers on their preferences for transmission services. But how do we compare those possibly high transaction costs with whatever costs industries might go through in trying to form coalitions? I just wanted to get your view on that.

MR MURRAY: We've not attempted to quantify those differences in transaction costs and with respect it would be very difficult to do that. We think qualitatively it's possible to analyse it through, by picking up the analytical framework by such as Meckling and Jensen who evaluate when it is that, or what circumstances is it more efficient to try and attempt to transfer information to the centre for decision-making, versus when it's more efficient to try and transfer the decision-making out to the peripheries where the information lies.

In these circumstances where the information on - the important information resides with the customers in terms of what are the services that they demand and what are the alternatives that they could contemplate, that that theory in the literature suggests it's better to allow the decisions to be made at the disaggregate level rather than trying to transfer the information to the centre.

MS BATES: Can I just clarify that for myself. Are you saying that - what would the industry EGB do in relation to such information? Would it collect it or not collect it?

MR MURRAY: In this process only on the appeal override on the part F. Up until that stage the industry EGB is a facilitator and has some functions to check various processes such as when the transmission provider or provider of a substitute service nominates those parties it believes will benefit from the service and who ought to pay for the service. There's a provision for appeal where those parties can say we've been wrongly

named, given the wrong votes. So, the EGB has that function.
MS BATES: So at the lower level it's not concerned with customer preferences?
MR MURRAY: No. Only on the limited appeal override.
MS BATES: Yes, I understand that. So, it doesn't incur the cost of collecting that information?
MR MURRAY: Correct.
MS BATES: Why is it that the Crown EGB has to do it?
MR MURRAY: The - Stephen indicated earlier, we can't be certain what process the Crown EGB would go through. The draft determination suggests that the Crown EGB would pick up and follow the part F processes, but would have a greater governance role and a greater ability to implement or force transmission investments to force Transpower to make an investment and to force the payment for those investments on to parties.
MS BATES: Why is that?
MR MURRAY: That's what the draft determination put forward as that counterfactual and in that circumstance the Crown EGB would, to make an efficient set of decisions, would need to gain an insight into what were the preferences of the customers, what were the alternatives that they faced individually and what were the supply options available to the provider that had intended to require to make an investment.
MS BATES: Okay thank you for that.
MS REBSTOCK: Can I take you back, I'm not sure if you've addressed the issue, if you did you can restate it for me, about how we should think about the transactional costs of coalition forming under the industry EGB. I mean I understand the information advantages but the actual processes that the industry - I mean we know what the industry goes through now trying to form coalitions. So, we have some idea, we certainly hear a lot about it. But how - I mean I know how we might think about the information costs of an EGB, a Crown EGB trying to get the information, but what about on the side of the industry EGB trying to form coalitions, how do we think about those transaction costs?
MR MURRAY: It's not the industry EGB per se that forms the coalitions.
MS REBSTOCK: Under that framework, sorry.
MR MURRAY: I think that the same way of thinking about it applies. What occurs there is that the provider of the service is interested in identifying who are the parties that would benefit from that service. The customers of the service are interested in identifying who are the possible providers of the service that the customer seeks and who are the other customers that would value that service to form the coalition. Again it's a problem of information.
MS REBSTOCK: Is it purely one of information or is it one of negotiating from different positions and trying to reach something that doesn't purely meet the commercial interests of each party but finds some middle ground.
MR MURRAY: Absolutely.
MS REBSTOCK: It's that bit - I understand the information bit, but it seems to me there's something more than just getting the relevant information. You actually have to find some middle ground and that involves something more than just information.
MR MURRAY: Yes, it does. I suspect the Commissioners wouldn't have had time but a number of people may have seen "A Beautiful Mind" which is about Nash and one of his propositions was whether parties who are in competition with each other could see through their individual actions to determine when a collective action would result in a benefit to them all that would be worth pursuing. For those who have seen the movie does it in --
MS BATES: Nobody went for the blonde right?
MR MURRAY: I'm trying to think of a way of phrasing that without --
MS REBSTOCK: I don't know if we should ask you about what the transactions costs are associated with that.
MR MURRAY: That's the same analogy I was trying to apply. Parties are looking

for a Nash bargain.

MS REBSTOCK: Sure they are, but how do we think about the transaction costs associated with them finding a Nash bargain. How do we think about that?

MR MURRAY: Perhaps the best, in terms of trying to put some quantification around it which we could do some work on, would be to look at the experience, and David may want to talk about it, of the MACQS process, where an equivalent type process is trying to determine what are - what is a common standard that should apply to a number of parties where their interests in that common standard would be different, but they all have an interest in there being a standard. We could do some looking at what has been the costs of that process.

MS REBSTOCK: If you want to come back on that that would be good because it's obviously an issue we have to look at.

MR CURTIN: Just one quick point. I understand part F is designed to deal with the theory, free ride and other problems putting together these collective decisions and the 75 percent threshold is obviously one of the mechanisms to get people to put their hands in their pockets and put up the structure in the first place, but there are still free riding issues left about once it's there others proceeding to use it and we come back to the issue I suppose of the FTR's. I just wonder whether in fact there is still an issue left of whether coalitions will form in the absence of certainty about the risks that the FTR mechanism is intended to address.

MR MURRAY: I can answer in two ways there. There are always free riding problems as part of the nature. As part of that presumption behind these rules is that the FTR regime will come into place. It's not a prerequisite in the sense that these rules address hold out problems and other problems that need to be addressed, but they will be significantly enhanced by a good FTR regime, as parties elaborate, the industry is still working through with Transpower what the detail of that regime would like or product would look like, but there is no widespread support for an FTR product strong, just a point of clarification on the part F process.

MR STRONG: Suppose you have a situation where there is a coalition of generators that wish to put in some transmission investment, my understanding of the process is then that proposal would go to the - is it the board firstly, or notify Transpower who would then look at the confirmed pricing methodology and assess the votes to be distributed to the parties who will - to voting parties. How would that match up, the coalition necessarily, with the voting parties?

What is required is that the intended provider of the service when it makes a proposed service through section 2 as to provide certain information with that proposal to the board. Included in that is a - the confirmed pricing methodology that will apply to that service. That is, it must first have gone through the section three process of putting to the board a pricing methodology for the board to evaluate against their pricing principles, and the argument behind that was if this pricing methodology is to be forced on parties who the 25 percent or fewer who vote against the arrangement, then that pricing methodology should have gone through some independent vetting process to ensure that it's an efficient methodology.

That methodology will determine the allocation of votes, because the votes will be allocated in proportion to the payments for the service and so you may get a coalition of say four parties who will pay different amounts under that pricing methodology, but they will know the pricing methodology and the amounts they will have to pay before they are asked to vote.

MR PALMER: Kieran, correct me if I'm wrong. Nathan, in your question if the generators already have agreed between themselves they would like to take the transmission service, there's nothing to stop them going outside the rules to approach Transpower and just to bargain over the price. Of

course on one view of section 30 that distribution for price would be per se illegal and they'd have to come to the Commission.

MR MURRAY: That's correct, there's nothing in section 2 that requires an individual generator or distribution company or group of companies who have agreed that they want a service directly to going to Transpower and saying let's negotiate terms.

MS BATES: One thing I wanted to ask about process when the example of Nathan Strong put up. When that comes to the board, does the board make any assessment of it or does it just allocate, does it make the vote allocation - I mean is there any information which is given to the voting participants?

MR MURRAY: Not by the board, no. It doesn't evaluate at that stage proposals. Its job is to try and protect the votes, that there is a confirmed methodology.

MS BATES: So it just processes it through and the industry participants will make their own mind up according to whatever pieces of information they happen to have, and any that's been put with - presumably put with the proposal.

MR MURRAY: That's correct.

CHAIR: Okay. That's okay Nathan? Right. Let's move on to I think the second leg of that one.

MR PALMER: That brings us to over-investment. Since we agree with the Commission's finding in its draft determination in relation to this issue I don't propose to spend too long on it, other than to touch on some points raised by Transpower.

Although there's uncertainty as to exactly what process would apply for determining transmission investments under the counterfactual, we accept the finding in the draft determination that a process analogous to part F would apply first with the Crown EGB making final decisions. In that scenario - this is paragraph K at page 38 - the applicant submits that the Crown EGB is unlikely to be a good decision-maker in the sense that it's likely to over-invest in transmission for the following reasons.

First is the information-gathering problem, that the Crown EGB would have to gain sufficient information to interpret customer preferences, also trade-offs inherent in those preferences, and determine a price quality and method of delivery that meets the demands of transmission customers and that suppliers are able to provide. Again in interpreting such information is far from costless.

For efficient decisions, information will be required also not just as to a particular transmission proposal in front of the Crown EGB but also alternatives to transmission. For example, relocating generation, or end use, are substitutes or can be substitutes to a transmission investment. Paragraph M just refers to the empirical evidence of Government bodies as decision-makers for analogous investments.

The second reason why over-investment is likely to occur as it is submitted under the counterfactual is the natural incentive for the Crown EGB and Minister to favour over-investment because it will be accountable if investments are not made, but it does not pay the cost of those investments. In the written notes here I refer the Trustpower and Genesis' comments in support of that proposition.

Turning then at paragraph O to Transpower's submissions, in paragraphs 93 to 99 of Transpower's submissions they set out four main arguments, four main arguments why they claim over-investment will not occur under a Crown EGB. The first at paragraph 94 is that the part F procedure will still exist. The applicant submits that although we accept that that is the likely counterfactual, however under the counterfactual there would still be a natural tendency for - there's a risk that the natural tendency for Transpower will be to concentrate its efforts not on that part F process which involves the formulation of

coalitions, but to concentrate its efforts on the Crown EGB as the ultimate decision-maker. The risk is that the parties will end up using this part F mechanism, or just going through the motions of the part F mechanism and the real gain will be at the Crown EGB level.

Paragraph 95 of Transpower's submission sets out the argument that the decision-making criteria for the Crown EGB will effectively be a net benefit criteria. That that can be relied on to ensure only efficient investment takes place. It is submitted that that won't be affective because of the informational gaps and incentives which the Crown EGB will face in the absence of facing the discipline for paying for investments which it authorises.

The third Transpower argument is at paragraph 97 which is that it will not be able to cover, or get a return on investments it makes which turn out not to be optimal because those investments will be reduced in value through ODV type technologies. The applicant submits on that that the experience from other jurisdictions suggests that in this kind of arrangement where an investor is told to go ahead and invest that those types of technologies either do not apply, or that if they do apply that they won't be used to second guess whether or not the investment was reasonable and prudent.

MR MURRAY: Commission, the written notes appear to be missing a line in that paragraph referring to optimal. Under the current ODV rules the optimal tests should be against the services demanded by customers. That is an optimisation is taken against expected demand for services. With the application of Transpower's ODV there isn't good information on the service characteristics demanded by customers and the ODV is currently carried out against proximities for that, such as the reasonable and efficient operated test.

MR PALMER: The fourth Transpower argument at paragraph 99 is that the Government ownership and also the requirement to comply with its statement of corporate intent will be an effective safeguard. However, it is submitted that she is will provide little in the way of restraint given the difficulty of the Minister or anyone else second-guessing these kinds of investment decisions because of the informational gaps.

In the middle of page 39, the two collateral points that I'd like to address, the first is in relation to paragraph 92 of the Transpower submission. That is that the Transpower argument is effectively that these incentives won't create over-investment, rather they'll straighten the stick from under-investment to a more proper level rather than going from a proper level to over-investment. We submit on that that compared with the proposed arrangement, there is no under-investment in the proposed arrangement, propensity for under or over-investment so the stick is already straight.

Secondly, under and over-investment can't just be weighed off against each other in the aggregate. It has to be looked at as a decision by decision basis. A bit of under-investment in Auckland isn't compensated for by over-investment in Bluff. It's a question of individual decisions.

Thirdly, and it's not a point that's written down but the third point there is that all the arguments that the applicant has presented in relation to over-investment are based on a starting point of the optimal level. They're not starting from any random point. They start from an optimal level and look at the incentives to over-invest from that point.

In relation to paragraph 104, the applicant submits that in relation to a submission by Transpower that well, if you've got a choice between under and over-investment it's better to go for over-investment. In relation to that the applicant submits that over-investment is not preferable to under-investment in competition terms, but definition in an over-investment situation the benefits of investment which include competition benefits, are outweighed by the cost. There is no basis for

saying that one form of sub-optimality, over-investment is preferable to another form of sub-optimality under-investment.

MS REBSTOCK: Can I just ask you a question on that. I accept the point you just made. It's not a question of whether one is better or not. Isn't it still possible that one, that there may be asymmetric risks and costs. On the other hand, neither is great but one has associated with it higher risks and potential costs than the other, even though the dollar amount is the same, because the consequences --

MR PALMER: Shows costs should be included in the dollar amount so if the dollar amount is the same the dollar amount, is the same.

MS REBSTOCK: You don't accept there may be some asymmetric nature to the risks.

MR PALMER: In a particular example it could exist, but the point is more that you can't say as a general proposition that one is better or worse than the other.

MR PALMER: Turning then to paragraph P which relates to Professor Hogan's argument that a regulated environment is unlikely to result in over-investment. We submit this is of little relevance given the differences of the US experience compared to the New Zealand experience and we've - Kieran's talked about that already today.

In conclusion, as Transpower itself has summarised the point in a submission to the Commerce Select Committee in June of 1999, a regulated dealing with quality standards and re-investment and infrastructure, will have real difficulties in making those judgments.

The danger according to Transpower in this submission being that the regulator will be over cautious and that this caution will lead to over-investment infrastructure. Given the long-term nature of these types of decision the impact of an erroneous judgment imposes an understanding in efficiency cost burden on customers, the applicant certainly adopts that view.

CHAIR: I had a look at that submission last night. Did that bill will go anywhere?

MR PALMER: There was the controlled goods or services.

CHAIR: Was that the proposal to introduce price control in?

MR PALMER: Yes. I think it was enacted, I'm not sure of the detail.

CHAIR: I can ask Transpower. They'll know.

MR MURRAY: My recollection was that was Mr Bradford's bill for price control and the house rose before it was reported back.

MR CAYGILL: It was reported back and the house didn't deal with it at the end of the 1990 elections, it wasn't carried over.

CHAIR: It was superceded by the bill that came out of your inquiry basically.

MR CAYGILL: That's exactly right.

MR CURTIN: Just one question if I could on paragraph P and Professor Hogan. There's a little bit of recession and counter-recession going on here about what the States can or cannot tell us. I'm not I have to say fully aware of whether transmission in the States is under the control of a single federal regulator or whether there are various state bodies that are also involved in transmission. I assume from the nods that there's a fair degree of evidence that might be useful from state regulation of transmission.

Just if I could refer to Professor Hogan's finding, by-in-large he's saying that the regulated system has not kept pace with the needs of the market and he says elsewhere there is little concern in the States that regulation is producing too much transmission investment, given the 50 odd states and the wealth of evidence that I suppose he's attempting to summarise there, I'd just be interested in seeing if you could defend your own assertion that the contrary is the case, with a little bit more fact.

MR PALMER: I'd rely on Kieran to do that.

MR MURRAY: Transmission across states is subject to FERC, but local transmission is subject to a - and distribution is subject to state

regulation. There are the grey areas between those two. Our assertion we're making here is that there isn't a comparable institution in the United States to the proposed Crown EGB, that there isn't the same comparable freedom of decision-making by an elected politician over transmission investments in the United States.

We're not making an assertion that under the independent regulator of electricity either at the state level or at the federal level in the United States that over-investment is occurring.

CHAIR: You have made that point a number of times I think haven't you, in relation to US regulators being protected from political interference or direction. I'm not sure how it's structured, but presumably state regulators are elected, I just don't know.

MR MURRAY: I'd need to check my - I assume that the Commissioners, State Commissioners are appointed by the administration. But I would need to check that.

CHAIR: So there is to that degree, they're not completely free from the political affiliation.

MR MURRAY: No, most independent regulatory bodies are appointed in some way, such as the Commission itself.

CHAIR: Like us, yeah, okay.

MR CURTIN: My recollection of the state level, Telecom's regulators, was that they were essentially appointed by the political administration of the day and I presume something would be similar in the electricity industry.

MR MURRAY: That's my understanding. I'm sure Professor Hogan will be able to clarify that.

CHAIR: I'd like if we can to deal with number eight before 12.30 and that will give us a reasonably clear run for the rest of the afternoon, hopefully.

MR KOS: Fortunately, Doctor Palmer's leading this too.

CHAIR: As long as you've been holding us up, as much as we're holding you up, I'm anxious to get that balance.

MR PALMER: I'm feeling quite hungry so I think I can deal with it in two minutes. The topic eight deals with a particular aspect of transmission or an effect of under the Crown EGB of its decision-making. In particular, the Commission accepted in the draft determination that the Crown EGB would result in reduced competitive pressures for transmission investments. The only real point of difference between the applicant, or the only difference we have in the views expressed in the draft determination, relate to the quantification of that difference and that's something that we had intended to deal with in the net benefit detriment section. So, in the interests of lunch, I'd be quite happy to leave it there.

CHAIR: I think you'd be supported on that. If that's the case, I better adjourn before somebody asks a question. We'll try and resume at 1.30 sharp and I'd just ask a question, because certainly Bill might want to talk to, where you think we are, just so that we can get other parties organised accordingly. My sort of predilection is that you probably will need the rest of the afternoon.

MR KOS: I think on our rather more optimistic timing analysis that was right anyway. But these are by-in-large shorter topics with perhaps the exception of number 13, the cost of capital issue.

CHAIR: I think we'll obviously give you as much time as you need this afternoon to see if we can finish your submission, but it's entirely over to you of course. All right, 1.30, thank you very much.

(Lunch Adjournment from 12.25 to 1.33 pm)

CHAIR: It's 1.30 so I suggest we resume. I think EGBL are willing for them to adjourn from 3.30 to 4.30 because Genesis have arrived. I think we tried to catch them but they'd gone to the plane. Then we'll resume at 4.30. I think probably 6.30 will probably be the end point because the stenographers have to head off by then, but if we don't make it we'll obviously come back in the morning. Let's resume on, item 9 we got as

far as. "comprehensive coverage".

MR KOS: Thank you Mr Chairman, members of the Commission, there's probably just one example which we think would be illustrative of a couple of points that we have made this morning and occurred to us over the lunch hour, you've put to us, so I think probably what I'll do is ask Mr Caygill and Mr Wilson to address it.

MR CAYGILL: Just very briefly. I think perhaps it might be best if we treat this as preliminary notice and we can give you documentation of what I'm about to talk about later.

CHAIR: I think if you could, because we'll probably circulate that to other parties.

MR CAYGILL: Mr Curtin I think in particular asked if we could think of an example that might demonstrate the gains that could be made from processes like part F, and then Commissioner Rebstock has said, can we isolate - how do you isolate the transaction cost offset against the benefit. We may struggle a little with the second part, but the example that we've come up with is, the discussion that has been going on in the context of MACQS in relation to the under-frequency standard.

Frequency is currently - the frequently standard is currently determined by Transpower. Members of MACQS have debated for some time how they would like under-frequency to be set. Frequency affects everybody, so in one sense this might be an example of the largest possible coalition one could imagine would be necessary for the members of the MACQS to have, and indeed the industry beyond just the members have come up with the frequency standard they want, but more importantly as part of that exercise an attempt was made to quantify the benefits of changing from the present standard to a different under-frequency standard.

That assessment was made independently and produced a range, he depending on assumptions, of between $3m, $3.2m and $20m net present value as a result of lifting the lower end of the frequency range from 45 hertz to 47.

MS REBSTOCK: That was a net benefit was it?

MR CAYGILL: Yes, a net present benefit. Now that's a large number, it's a range, not so large at the bottom and large at the top. We could I think, though it might take some effort, count the number of meetings that were involved and assign some cost to those processes and I don't think that would be a foolish exercise to undertake. I don't think it's been done, but we could probably do that to try and isolate the transaction costs in that example, bearing in mind the point I made earlier that this is possibly the largest coalition one could ever imagine needing to be assembled. But it is a real example. It's a real example of a benefit calculation which has been done and I'd be happy to - the documentation I mentioned earlier, I'd be happy to get that report that was made for the Grid Security Committees Working Party if you wanted A) to verify the figure and B) to see how that kind of calculation was made.

The contrast that stands out for us is, here is a process very like the rule making process we'd been talking about. It's precisely the process that is intended to be used again in future under the rules relating to common quality, yielding a significant advantage as compared to the standards that apply at present, which are determined far - precisely by a central decision-making mechanism.

MS REBSTOCK: How far back do you go in that process? That debates been going for years.

MR CAYGILL: Indeed, and with respect it wasn't until MACQS was established and governance arrangements were agreed that the industry had a way first of authoritatively reaching a landing on its preference and secondly, engaging with Transpower in relation to that.

Now, I don't mean to beat up on Transpower here, Transpower were

asked to initiate the processes which led to MACQS by the Government in 1997 when its statement of corporate intent was amended. But absent such mechanisms, as you say, the debate about the appropriate frequency level had been going on for a long time.

MS REBSTOCK: The reason I made that comment was when you calculate the transactional costs of the meetings do you go back to when MACQS was put in place?

MR CAYGILL: I think it would be reasonable to include the costs of the meetings which occurred in relation to that standard, and not the meetings involved in setting up the governance arrangement.

MS REBSTOCK: No. No, but I mean going back to the period when MACQS provided a forum for it to be addressed.

MR CAYGILL: Yes.

MR WILSON: It's relatively easy to address those costs because a specific working group was established by the Grid Security Committee, it was only dealing with that particular issue. It met nine times since March 2001 in order to resolve the issue. Okay, so it was a difficult issue, a large coalition, nine meetings.

MR MURRAY: Commissioner, the other aspect of that agreement is that the change to the frequency standard is a pro-competitive change, in the sense that the current standard can be met by - the standard prior to the new agreed standard, could be met by the existing hyrdo-stations, but could not be met by new combined cycle plant technology.

So, by lifting the standard it enables new technology, provided a new technology to enter the market more easily.

MS REBSTOCK: And there were some parties that wasn't in their commercial interest I take it then to support the proposal?

MR CAYGILL: I think one could reasonably conclude that and notwithstanding that those particular parties all, as far as I am aware, have supported the change and certainly I can think immediately of particular parties who might well have had a contrary commercial interest, who have nevertheless supported the change that came from the working group.

CHAIR: Thanks very much. If you could provide us with what cost information comes out of it. I think the indirect benefits that Mr Caygill mentioned are obviously a very important other side of the equation. Okay. Well, if that's all on that one we'll move on to item 9. Mr Kos please.

MR KOS: Thank you Mr Chairman. I'll deal with our submission on this quite briefly. What we have done on page 43 is to set out a number of elements that feature both - all in terms of the rulebook process, some that take effect before the rulebook itself takes effect, some that follow, which are designed to achieve comprehensive coverage and in A, I point to the fact that we have to have determination of existing codes, the system operator that David Caygill referred to yesterday.

There's the requirement that the industry needs to be resolved. If there are enough, sufficient members to have a robust and credible process, then once the rulebook takes place, takes effect, there are a series of regimes set out and they're summarised there, which provide both for certainty of obligation on the part of members and also to assist in the enforcement of recovery for services provided to non-members, and that's the quantum meruit issue.

An issue which Transpower has challenged as - in terms of its effectiveness as being a myth, and the purpose of this short submission is to attempt at least to explode its mythical status and to build it up into something somewhat more than that, because as it happens it is somewhat more than a myth.

The point we make at the bottom of 9.7, though first of all it's not just a quantum meruit issue. We've talked about the examples of other features and asset out in 9.1 which show that there are other methods apart from quantum meruit to assist in the process of getting comprehensive coverage. Comprehensive coverage is a common feature of

both models because the GPS clearly signals the same desire.

Then in the middle of page 45, or secondly at C, we note that Transpower's submission in effect mis-states the doctrine of quantum meruit and it fails to perceive, we say, the practical effect of the rulebook drafting on minimising both doctrinal uncertainties and incentives for non-members to stay outside the rulebook while receiving rulebook services, and I've then summarised in the succeeding section the essence of the doctrine, both its history in I, the recent observations of Justice Fisher in relation to the Meridian case, which was the counter-part of the Cobb case that was mentioned this morning as one of the examples of allegedly anti-competitive behaviour.

CHAIR: Was that really a case settled by the judge or settled by the parties?

MR KOS: It was resolved by the judge. The final outcome was settled by the parties, but the principles were established by the judge. We make the point at 3 that there's unlikely to be any benefit to a non-member contesting rulebook pricing given that the rulebook minimises the room to contest value by collecting industry agreement as to what reasonable value is.

While that doesn't prevent a non-member engaging the contest, we say first of all that a court will have a very high regard for the united evidence of market value resolved under the rulebook, and more-over, that there's a lack of incentive because of the next point, that a non-member will end up paying a far higher price going down the quantum meruit route than under the rulebook. Not only will they have to meet their own legal and other transactional costs, but they'll have to pay EGB costs either as part of the extra quantifiable cost component of value, or else as part of the judgment awarded.

So, we suggest that the costs to the EGB of pursuit are accordingly nil or minor, and the suggestion that repeated experiences of cases costing over a million dollars on quantum meruit claims is simply nonsensical. We submit that the rulebook provides efficient incentives to achieve comprehensive coverage and the cost of securing non-member, if any payment compliance are minimised, to the extent they continue they're a necessary function of the preferred self-regulatory model.

MS BATES: Are you putting forward that EGB's actual costs will be covered by a court order are you?

MR KOS: Yes, in the sense that the computation of value set out in part A, section 9, rule 2.1, includes as part of what the assessed value of the service is, the cost of cost enforcement. That's not silly when one thinks about it, because typically in a situation of casual or uncertain supply --

MS BATES: You mean that will be part of the judgment rather than any costs order?

MR KOS: Precisely. Part of the assessment of value. It's a premium that you would expect in a situation of cash or uncertain suppliers, the premium for risk that you'd expect a supplier to charge.

MS BATES: Have you got some authority that that would actually be taken into account in a quantum meruit award?

MR KOS: No more than the authority of logic.

MS BATES: I know logic is a powerful authority but I just wanted to know if there was any case law supporting you?

MR KOS: No, can I advance the principles again. When one is looking at what a reasonable value is, and whether the supply is casual or uncertain, it's not part of a contractual mechanism, there is an extremely respectable economic argument to say that the price for that supply in a market will be higher than a price under a contract where there is continuous obligation and uncertainty of recovery. All quantum meruit comes from an economic evaluation.

MS BATES: This is not cost enforcement is it, the price will be higher, you say, because of the uncertainty of supply. I'm just trying to link that

up to the cost of enforcement which you say is also part of the --

MR KOS: Yes, the linkage is because of the uncertainty, because a supplier will incur costs either of marketing or of recovering cost, recovering payment, then the supplier's price in the market will be set at a high level. So, in that way it comes back into the assessment of reasonable value.

MS BATES: I do follow the argument, yes.

MR KOS: I think the other important, and really at the end of the day probably the most important argument though, is in this constant theme, I keep coming back to, of comparing the counterfactual, looking at the counterfactual, we talked about this previously this morning and we dealt with it at the top of page 46.

What we say is a myth, is that regulatory price recovery under regulation would be imbued with a certainty and predictability missing in the case of quantum meruit, and as, I think it was James mentioned this morning, regulatory recovery is clearly susceptible to judicial review just as Transpower's threat, if it is a threat, in relation to conditions neatly illustrates. So that the purchaser who is determined to contest will contest via one mechanism or another, and if it's not an argument over quantum meruit it'll be an argument that either unfairness has accompanied the calculation of price or the regulation itself in some respect is ultra vires.

MS BATES: There's a limited compass to argue the review?

MR KOS: Yes, but little restriction on the ability to advance the argument in the first place.

MS BATES: Well, yeah, but you know, there are realistic arguments and realistic arguments.

MR KOS: We both now how difficult a strike-out application by a defendant is in a case like that. Well, I do, I'm sure you do.

MS BATES: Bates you hope I do?

MR CURTIN: I suppose we should just keep our eye on the counterfactual as you are suggesting. But I just wondered, one of the losses if you like under the present - the proposed arrangements is the inability for parties to come to independent physical trading agreements. Perhaps they would like long-term supply arrangements between themselves for good commercial reasons.

I think the article on the Californian crisis mentioned the ability of parties to engage in long-term contracting is a generally desirable feature. So, I'd just like to explore whether in fact it's iron-clad that the counterfactual would take a fairly rigid approach to comprehensive coverage, and would indeed require all trading on the spot basis, through a single market and nothing else.

MR KOS: That anticipates in fact section 11 of the submission. I could take it now or take it then. I wouldn't mind answering the question, having gone through the arguments in relation to that, that particular proposition.

MR CURTIN: That's fine.

CHAIR: We'll come back to that then. Anything else on this particular one? Just a question again which Mr Caygill may recall from his earlier incarnations, but my own feeling is that fees by regulation or charges by regulation usually are fairly sustainable. It's got to be a major issue to seek a review of a charge made by regulation, certainly in my experience.

MR KOS: I think that's the point that Commissioner Bates was directing. I accept that the - it is easier to run the argument if you're dealing with a contractual or a vacuum which would occur in a quantum meruit than a challenge to a regulation, but my submission is simply that particularly at the early stages you can anticipate that a determined defendant will fight under either regime, and there are other building blocks for a case under either regime.

MS BATES: You only need to get one good precedent to put paid to some of it.
MR KOS: And that point is quite right and applies equally to quantum meruit.
MS REBSTOCK: Can I just ask you a question with respect to one of the elements with respect to the comprehensive coverage. That is the statement in B.1 on page 43, under 9.1, that no member may transact with a non-member except on the terms of the rulebook. It certainly has an exclusionary tone to it, it suggests possible breach of section 29 and raises possible concerns about a substantial lessening of the competition and I would just like to invite your comment on those provisions and some of the concerns that have been raised about.
MR KOS: I'll ask James Palmer, who's far more a competition law expert than I am, to answer you but can I say this is the particular aspect of the rulebook which we identified as requiring authorisation in any event.

I'm not sure that there is going to be a material distinction in terms of the process that arises as to whether it's a section 30 or section 29 issue. James will comment on that.

MS REBSTOCK: I'm interested in the bit about, does it substantially lessen competition and issues it may raise in the net benefit analysis.
MR PALMER: In relation to a substantial lessening of competition which is effectively what the section 29 issue boils down to as well, with the defence that was introduced in May last year, this arrangement as compared against the counterfactual to determine whether there's a lessening of competition. In relation to comprehensive coverage it's clear from the GPS that it would be comprehensive under the counterfactual as well. So, between those two there is no lessening of competition.
MS REBSTOCK: Is it that clear that it would have to be comprehensive under the counterfactual?
MR PALMER: In relation to trading arrangements there may be another issue which Stephen will get on to, but in terms of everyone being on board I think that is quite clear from the GPS.
MS REBSTOCK: So in the more narrow sense we'll come back to that later will we?
MR PALMER: Yes.
MS REBSTOCK: The other question I wanted to ask you about is the - if I understood the comments earlier you assert that everybody's likely to be members. I think you said there was no reason to believe you would have people standing outside the agreement.
MR PALMER: The draft determination said that few, if any, people would stay outside.
MS REBSTOCK: I know what the draft said, the draft says what the draft says, but it is a draft and you should consider everything up for grabs because that's how it is. So, we need to explore, I think it's still important for us to explore some of the points that other people have made because we may change our position on anything in light of submissions?
MR CAYGILL: Everyone who matters must be in, as a matter of interpretation of the rules. What I mean is, if one looks at part A, rule 7, which specifies when this rulebook will come into effect, it cannot come into effect until the system operator has provided written confirmation that the rules - that the system operator is satisfied that the rules are binding on sufficient members of the industry for the system operator to have confidence in the effectiveness and integrity of the common quality rules.

So, if someone is outside the arrangement it is someone who is too small to have any impact on the system operator's capacity to ensure the common quality standards, frequency and voltage. If someone is sufficiently large to be important then the agreement does not begin because the system operator has not certified that the common quality rules can be delivered.

That's not intended as a trick. It's a very real --

MS REBSTOCK: I just wonder what you mean by important?

MR CAYGILL: Would impact on the effectiveness and integrity of the common quality rules. The system operator has said informally that they have a clear idea who will need to be in and it's quite a list. I can't quantify it but --

MS REBSTOCK: Let me ask you this, who's not in it. It's quite a list so where have they drawn a line?

MR CAYGILL: I have never seen their list. We've said we're going to need a list but we can get to that. What the point seems to me is, Transpower have said that they are concerned that quantum meruit may not work effectively, that there may not be the comprehensive coverage that they believe is necessary, compared to the counterfactual and we say well have a look at the rules. The rules provide that you in particular, wearing your hat as system operator, have to be satisfied that everybody who needs to be in is in.

MR KOS: That's the melt. The basis is then in the form of the industry EGB which also has to certify, and that's set out in A.2. A.2 is the system operator, A.3 is the industry.

MS REBSTOCK: Why do you need provision B.1 then if you're in effect saying everyone who matters has to be in by definition?

MR CAYGILL: I think B.1 possibly deals with the other potential situation. The rule that I mentioned is a rule which governs the starting conditions. B.1 may address that, but it also addresses what happens if someone seeks to leave.

MR KOS: In part. But the other feature is that B.1 is there designed for efficiency purposes because by providing the services provided to non-members on the same terms as services under the rulebook, it diminishes the opportunity for the non-member to argue, oh my service is fundamentally different from that one over there under the rulebook, so you can't use rulebook pricing as the means of working out what the reasonable value of the service is in our non-contractual relationship, which then has to be sorted out on a quantum meruit basis. That's the reason it's a rationalisation of price.

MS REBSTOCK: I'm just trying to figure out who these non-members are. Who might they be?

MR KOS: Some consumers, some major consumers.

MR CAYGILL: An embedded generator whose generation is de minimis, is not sufficiently significant to impact on the quality standards of the system as a whole, who chooses to be outside, the system operator is able to say well they have no impact on quality, that's okay.

CHAIR: There is a major user who in their submissions say they're unlikely to join. Will they have the same impact on quality as a generator?

MR CAYGILL: I don't know. It's not just a good question for the Commission to pose, it's a serious question and one that we realise we have to think through ourselves, but if I could reply in this way, that same letter is also signed by two other entities who clearly have to join.

MS REBSTOCK: What does that mean, 'they have to join'? They have to join for this to be put in place but they don't have to join right? I mean they may choose not to join?

MR CAYGILL: No, well in that case the rulebook doesn't operate.

MS BATES: Doesn't go ahead.

CHAIR: There's the majority you mentioned yesterday, that from an industry point of view you need it before you start it.

MR CAYGILL: That's before we opened the rulebook for membership and then as members join you get to the point where we are now waiting for the certificate, or the written confirmation from the system operator and the decisions of - the system operator makes a decision as to whether the coverage is sufficiently comprehensive so that common quality can be guaranteed. Surely that can't occur without Meridian being a member, can't occur without Transpower themselves joining.

Independent from that, NZEM, MARIA and MACQS need to be satisfied

with the coverage because they need to agree to wind up, to pull back, and then finally, the governance committee itself - it will be actually the new governance board because it will be elected by then, needs to say well, yes we're satisfied by all of those things and so we agree to proceed.

MR WILSON: There's a minimum period of two months and a maximum period of four months in which those conditions have to be fulfilled. So, it can't - it's two months after the election of the board is the first opportunity for the rules to go live in an operational sense, and then if that - if we haven't satisfied those conditions by the time we're four months after the election of the board, then the arrangements lapse.

MS REBSTOCK: It comes to mind, sometimes we dismiss benefits, if we think there's a possibility they may never accrue, and yet time will elapse before an alternative arrangement can be put in place.

MR KOS: I don't think, with respect, this would be an appropriate occasion for that when we think of the context in which the application comes. It's not an individual commercial proposal, it's one which fills a vacuum which plainly the industry is working towards and which, in the absence of, we have the legislative outcomes.

CHAIR: Yes, I mean --

MR CAYGILL: And the Government has expressed a preference for and is therefore presumably interested in at least thinking about taking a position in relation, for example, to the entities that it owns, that are within the industry.

MS REBSTOCK: I'm not questioning that. It is one of these things that sometimes comes up when we do net benefit tests. So, I hadn't thought this true. I just wanted to mention it to hear the response. So, don't take it as an expression of a view because it isn't.

CHAIR: It's just an interesting dynamic, if a shareholder says X, and for good technical reasons the entity in which the shares are held says no, anyway that's not for --

MR CAYGILL: One imagines some discussion will ensure, and I think that's exactly as it should be.

CHAIR: Exactly, I'm not postulating the outcome at all but I just make the point. I think linked to it is the contestability issue.

MR KOS: Yes, the first one which is number ten service provisions.

CHAIR: Perhaps you'd like to open up on that Mr Kos thank you.

MR KOS: Again I think I can be quite brief Mr Chairman members of the Commission. I'll ask Doctor Hansen to assist me. In very brief terms the Commission indicated in its draft determination view that the system operator and other service provider roles were likely to be more contestable under the industry model than the Crown EGB model, a view with which the applicant agrees.

The Commission and the applicant's experts, Murray and Hansen, both assess the potential benefit at some $3m to $6m, but the opponents, the opposing submissions, particularly from major users and Transpower have suggested there will be no material difference between the two proposed arrangements and the counterfactual on this issue. We simply endorse the draft determination conclusion, it's 10.7.A and I'm going to ask Doctor Hansen to comment briefly on remaining points in the notes.

MR HANSEN: Thank you. These comments relate to a submission from Transpower via New Zealand Institute of Economic Research, NZIER. The institute has asserted that the service provider roles are essentially non-contestable because they believe that those roles involve specific human capital investments, namely once the first service provider has been appointed, they become - they learn by doing, and as a result of that no-one else is able to compete with them. Our responses to that are three-fold.

One, in concept, much - human capital by definition is embodied in people and not in firms. We do accept firms sometimes develop their own dynamic and tacit knowledge, but a large part of the learning is actually

in people and people of course can switch firms. We don't have slavery any more, or we never did in New Zealand I guess. So, we don't buy that argument.

Secondly, the evidence is that interest with re-tendering of services has actually been very healthy. There have been, depending on how you characterise it, either two contracts or four courts that have gone right through a re-tendering process. The reason I say that is because in the case of reconciliation there's been both a MARIA re-tender, and a NZEM re-tender, contracts that got re-tendered at the time on a parallel basis.

A similar thing happened with the, one of the NZEM type contracts, but in all of those cases there has been healthy interest from parties and in some of those cases been more than one bid, but not in all.

Thirdly, in regard to re-tendering, I draw the Commission's attention to the process that NZEM began in February 2000 where they began the tendering process, or re-tendering process for contracts principally held by Transpower, which is the scheduling dispatch and grid operator. Those three contracts now constitute the system operator contract, they're bundled together plus another contract, that are called 'common quality co-ordinator' under MACQS, now called 'system operator', but the point there is NZEM did begin the tendering process in February 2000, quite a long way in advance of when the contract was coming up for renewal, because of the complexity and overlaps between NZEM and MACQS in terms of the dispatcher role particularly.

In effect, the process got overtaken by this outcome of the Government policy statement in August of 2000 and was put on hold. So we have a reasonable level of evidence to suggest there will be a level of contestability.

Point C on page 48, the institute asserts quite incorrectly, in our view, that Transpower's owner, namely the Government, will be the one that decides whether the system operator role becomes contestable. Our advice is that the system operator contract is a contract, just that, between Electricity Governance Board Limited or will become a contract between Electricity Governance Board and Transpower, as the system operator when that contract will have a finite life, when it comes up to the end of its - to its termination period it is the Electricity Governance Board alone that will have the authority alone, how it wishes to relet that contract or not.

Just lastly, in D the institute raise an issue around copyright, and Malcolm Alexander may wish to pick up or comment here, but the issue is, under the current arrangements with New Zealand Electricity Market, that is not a corporate body, it is not a legal entity. So, NZEM itself could not actually own copyright. For that reason, it was M-Co that took the ownership of the copyright and that, in the terms of the current rulebook, has no follow-over in the sense that each of the project parties, M-Co, LECG and Concept Consulting explicitly in the contract with Electricity Governance committee signed away any rights of copyright.

I think Malcolm would like to comment on various obligations that M-Co have made, commitments sorry.

MR ALEXANDER: First of all counterpoint this arrangement with NZEM for example, and MARIA for that matter. But there is clearly no copyright that's been passed over by the parties, but for the state of NZEM it is M-Co's policy that it will not in any way let that stand in the way of contestability, as an advocate of contestability.

MS REBSTOCK: Can I just clarify one point Mr Hansen made, the selection of the system operator at the end of this term, is that to be made by the board, is it something that will be voted on by the membership?

MR HANSEN: My understanding is that the intention is and the process is already underway, where not only a system operator but the other parties who have

contracts under existing arrangements become the first operators under the new arrangements for minimal disruption.

MS REBSTOCK: At the end of that period who assigns the contract, the board, the independent board, or is it voted on by the membership?

MR KOS: The board appoints service providers.

MS REBSTOCK: And the board also has the discretion to set policy vis-a-vis contestability.

MR CAYGILL: Correct, subject to the guiding principles which I believe have something to say in favour of contestability of services,

MS REBSTOCK: Yes in that sense you wouldn't necessarily expect a difference between the EGB board, industry board, or Crown board. In both cases they would - would there be any likely difference on that?

MR KOS: I assert two. Shall I try two, and see if the chairman agrees with me. This is the essence of the $3m to $6m, point of difference between the two models.

The first is that there would be less pressure on a Crown EGB to change the current system operator from Transpower to another entity.

Secondly, it is the submission of the applicant that a Crown EGB would not be susceptible to pressure from Transpower to remain in that role. That's where that evaluation arises, is that your view?

MR CAYGILL: I was simply going to observe that all we know about the Crown EGB for sure is what is in the legislation. There's nothing that identifies any obligation on it to maintain contestability. Presumably one might posit that it would have some sympathy for that, but for the reasons that Stephen cites, one suspects that it's also not unreasonable to say that there may be tugs in the other direction.

CHAIR: Just to follow that on, I mean this has been an issue of some moment for quite a long time hasn't it. I mean the question of system operator contestability. In other jurisdictions, other cases where the grid owner or the grid company or the grid is not the dispatcher etc and so on. Is that reasonably common elsewhere?

MR CAYGILL: Two models basically, in some jurisdictions when there's an independent system generation, in others there are not.

MR ALEXANDER: I just say it's very common.

MR KOS: I think the important feature too is that in this rulebook for the first time, provision is made for that split. The system operator is a separate provision contract.

CHAIR: I accept that. Even in your submission you acknowledge this issue has gone up for discussion and debate and has been deferred on a number of occasions. All I'm asking is, there are precedents elsewhere where practically the service provider role is contestable and is operated like that.

MR MURRAY: Exactly and the closest example is Australia.

MR CURTIN: I was asking about the other service provider contract. I was just interested what sort of companies tend to bid for those sort of contracts, what sort of expertise do they have, what sort of industry background. I'm trying to get a feel for the viability or the reality of a going market in bidding for those service provider contracts.

MR ALEXANDER: Well running through them, just off the top of my head, if you want to take something like a system operator contract there are companies such the Irish grid ESBI who is in that business where they have the contract in Alberta and are contesting contracts elsewhere. PJM is in the business of expanding its spread and is competing as the RTO unfolds in the US.

Reconciliation, when that came up a few years ago there were a number of - two or three parties from memory, consortia, one of whom was associated with a market participant as a matter of fact, so that's IT a function to some respect, the current incumbent is to decipher who is a subsidiary at Transpower.

Market administration is a combination of services around advisory,

surveillance compliance, and general administration and market information through Comet(?). So a number of parties could conceivably bid for that, it would depend on how they want - similarly they would be in -house. The pricing manager is a tricky one. That may - the need for that may be overtaken by events in terms of market evolution in terms of the pricing model. Then the clearing manager, again, a number of parties could offer, it seems to us, a clearing service. It's an IT function basically. Who have I missed?

CHAIR: There are sufficient examples of where these are contestable and you've had people obviously bidding for those services here.

MR ALEXANDER: Certainly our business has grown internationally relying on contestability.

MR CAYGILL: Perhaps we could answer this way. I don't think there is a service that we've identified the need for that we do not see being able to be contested by a number of potential participants.

MR ALEXANDER: I'd simply say that I don't go a single day without thinking about contestability.

CHAIR: You would have gone broke if you hadn't. All right well, if there aren't any further questions.

MS REBSTOCK: Can I just ask one other point of clarification. On the earlier discussion when you were explaining to us the system operator would have to indicate that we had enough of the players who needed to be involved, what happens down the track if somebody decides to leave the arrangement who is a member but is critical to the operator?

MR CAYGILL: The provision to which you yourself drew attention, they may - the terms of the rulebook will still apply, is the fundamental answer except that it's not quite as simple as that. Before they are allowed to leave they need to demonstrate that appropriate arrangements have been put in place.

MS REBSTOCK: So at that point --

MR CAYGILL: They can't simply walk away.

MS REBSTOCK: No, they can't simply walk away, but at that point does there open up an issue about there being some cost in the future to not having comprehensive coverage?

MR WILSON: Those arrangements they would have to satisfy the board on in order to leave, would encompass things such as an appropriate arrangement for dispatch, for reconciliation, for switching customers, depending on the nature of the participant that was resigning. So, they would have to satisfy those - the board - that those arrangements were appropriate and in effect we would achieve comprehensive coverage through that mechanism.

MS REBSTOCK: One of the reasons I ask this is, it kind of looks like once you're in you're in, and there's really no escaping. So I just wonder if it raises any issues about ongoing contestability to this arrangement if you can't in effect exit, because even if you do you basically have to demonstrate that all the provisions of the arrangement are maintained.

MR CAYGILL: With respect, I think we've actually tried to do the opposite. We've actually tried to provide, you know, as much flexibility as the system - the structure will tolerate. Whilst ensuring that in particular system security issues are addressed. This is, with respect, a very good example of the tension that lies behind the debate in relation to many issues between security considerations on the one hand and over competing objectives. If security requirements or any other requirements can be met, well then the arrangements don't need to be comprehensive in other respects. Hence the design of rules - hence rules which say no, you cannot leave, but you cannot leave unless certain requirements have been satisfied.

If those requirements are satisfied, I might also say there are rules which provide for alternative forms of reconciliation for example, or alternative ways of achieving the same outcomes which provides a measure of contestability, not in a membership sense, but an operational

sense. Hard to know whether they would ever be populated but they are there because we're not trying to lay down a universal template where there's simply no technical need to do that.

MS BATES: If there is a dispute about the leaving that dispute is resolved in the rules themselves is it?

MR KOS: Yes because the members will still be members.

MS BATES: Yes, because I'm thinking about enforceability issues.

MR CAYGILL: Yes, however - that must be the first answer, and then of course even that, there's no exclusion of any civil jurisdiction so if, you know --

MS BATES: There's no exclusion of civil jurisdiction so somebody who wants to leave can take it to the Court. You'd take it to the Court and seek some sort of injunctive relief, is that how these would be enforced?

MR CAYGILL: I don't think one can be certain. All one can say is no remedies have been excluded, we're not trying to confine people's rights in any way.

MR KOS: If you're enforcing against a member, your primary route would be to do so under the rules, which is a contractual mechanism and if there was then non-compliance by the member with say the dispute resolution process, then you might have to go to court to support that process.

CHAIR: I would have thought as part of your voting process on whether the thing should come into effect, people are give a lot of thought to this aspect of it I would have guessed. You're not going to go into this arrangement without having thought through exactly that point.

MR CAYGILL: And there have been people who have said this is unreasonably comprehensive, you are extending your coverage unnecessarily and people such as Transpower have said, it is absolutely essential that this is comprehensive otherwise we can't operate. So, we've said okay, well, you determine whether you can operate or not, and beyond that we try to - the rules have tried to identify what are reasonable objectives and provide that they can be met without over-reaching.

CHAIR: I take your point. I'm sure we'll ask Transpower the same question. All right, well look, I'd like to move on to 11 if that's agreeable which is linked to contestability again.

MR KOS: If we move to that, perhaps just a couple of preliminary observations before I touch on the notes. The purpose behind comprehensive coverage and the restriction here is a restriction against physical, alternative physical trading arrangements and its purpose in doing so is to achieve a comprehensiveness of coverage and of physical inclusion which, in the applicant's submission, is consistent with the expression of the Minister in the Government policy statement.

It's important to note that it is a restriction only of alternative physical arrangements, not of alternative financial arrangements. So, bilateral arrangements are still possible within membership of the rulebook because of the ability of a member to enter into bilateral financial arrangements such as hedges or contracts for difference outside the prescribed multi-lateral offer and dispatch mechanism in the rulebook.

There is also the capacity in the rulebook of course to apply for exemption or to promote rule change. So, the prospect of a liberalisation of that code is there, in the sense that one could move from the existing rules out of them through exemption, or else by promoting a rule change itself. Then, of course, finally there's the capacity to resign and establish alternative trading arrangements, although as we've just canvassed that, that has its own issues.

So, the question then becomes well, what is the difference between this and the counterfactual? That's what Commissioner Curtin was driving at, and the submission of the applicant is that in fact there would be little if any difference between the counterfactual and the proposed arrangement. Indeed, bearing in mind a constant submission the applicant

has made that the grid operator is likely to have a greater degree of influence on a Crown EGB, and given that restraint on alternative physical trading is a matter strongly desired by the grid owner, as Contact submitted and as we've noted at 11.5, competition is in fact arguably more likely under the proposed arrangement because the system operator would be more likely to be heeded by a Crown EGB and incentivised to keep not only service provision in-house but also to restrain against alternative physical trading.

Then at 11.7 we have set out essentially our response to the submissions by Comalco today and Trust Power on this topic, and we've started by noting that there is, in this issue, a trade-off between the benefits of alternative trading arrangement competition begins the increased transaction costs in the coordination of physical dispatch, increased system security risks and risks of free-riding that arise from an exempt approach.

In our submission, if competing arrangements are economically efficient, then they are more likely to develop under the proposed arrangement, but under the counterfactual, there are two or three reasons for that. The first point we make at C) is in relation to the initial rules, which are likely to be the same under both arrangements, there's no reason to think that the Crown EGB would be more likely to grant relevant exemptions. Indeed, as I've just submitted, to the contrary.

Secondly, in relation to rule changes which facilitate the adoption of competing trading arrangements, similarly there's not reason to think this is more likely under the Crown EGB and the third point is the one we were connecting to before, that to the extent that Transpower has more influence on the Crown EGB the development of competing trading arrangements, is in fact less likely in our submission. So that is background in terms, Commissioner, of the two experiences and we could debate it back and forth, but that's the position and experience we bring.

The last point we make is that if the Commission doesn't accept the applicant's items on this aspect, is not satisfied that the benefits of the proposed arrangement outweigh the competitive detriments, then we have proposed a condition that the rulebook be changed to provide that the board can approve exemptions under part G for pricing reconciliation and other matters, and under H in relation to clearing settlement.

That's designed to facilitate the industry parties engaging in alternative trading arrangements if, and it's expressly put in these terms in the proposed condition, if there is a net efficiency benefit. That's the essential core submission on this issue.

MR CURTIN: I suppose on page 50, your point D there about the likelihood or otherwise of a Crown EGB looking favourably on competing trading arrangements. I suppose what I was thinking of there was, let's say a generator and a purchaser go along to a Crown EGB, bend the Crown EGB's ear with an argument along the lines of, we don't want to see winter 2001 again, we would duly like to contract with each other between the two of us for a five year, ten year supply arrangement. You leave us to our own devices and there won't be any more public embarrassment for you from shortages and dry winters and whatever argument gets run and perhaps the Crown EGB might listen to that type of argument.

MR KOS: It will of course, like most beings, has got two ears and the other ear has the system operator speaking loudly into that and that's going to create a confused message at once. That will be an opposite message.

So, to the extent the issue is a physical one, the system operator will be bending the other ear of the Crown EGB, to the extent the issue you have raised is a financial issue, then this does not preclude contracts for difference and hedges anyway to meet that need, and is there anything you want to add to that?

MR HANSEN: Just in terms of that particular example, IACFD or contract for

differences is generally going to be preferable to a direct physical contract, because any one generator could run out of hydro or whatever source it has. So, a CFD actually in terms of secure and supply is a much more preferable arrangement.

MR CURTIN: I understand that. Just by way of information, I wonder if you would care to update us, just on the ready availability or otherwise of CFD arrangements, or hedge arrangements. From time to time there have been arguments about whether hedges are available when you need them and all the rest of it.

MR HANSEN: I note the Market Surveillance Committee report made some comment on that. That was of course last year. I personally don't have any further information on that.

MR MURRAY: Commission, I suggest maybe Genesis, that's following us will have better and more accurate information than we do on that point.

CHAIR: The other generators will also will be here. Perhaps we can ask them too.

MR WILSON: If I could just make one other comment in response to Commission Curtin's comment. Any parties that wanted to trade outside of these core arrangements would still need to satisfy either the Crown EGB or the industry EGB that they had a proper arrangement for reconciling with the other market participants, reconciling quantities, an arrangement with the system operator for the dispatch of their plant, according to some basis and if they were a retailer involved an arrangement to switch customers. If they're an asset owner an arrangement that satisfies the system operator that they can go on to meet their common quality objectives, and some arrangement in terms of metering. They're all elements that are embodied in this rulebook.

They would still in each case need to convince either the Crown EGB, or the industry EGB that they had those arrangements in place.

MS BATES: That's once they are members, they'd have to be members?

MR WILSON: It applies in either case is what we're suggesting.

MR CAYGILL: It's a consequence of using the grid, there's absolutely nothing to stop a consumer and a generator linking and if they were linked via an independent system of lines, no law, and certainly nothing in these rulebooks stops them entering into any kind of contract they like, but as a matter of more likely hypothesis we're talking about somebody who is physically linked into the grid, and that connection means that whatever their financial arrangements might be, their behaviour as generator and as customer, is capable of affecting everybody else. The price can be insulated, but a number of other requirements need to be negotiated, not because our rulebook says so, but because it's the nature of their --

MS BATES: Use of the grid is that what you're saying it's condition - I'm just trying to think of the legal basis on which you're putting forward - no doubt you're right, is that the legal basis, that they can't use the grid unless they meet these certain conditions?

MR CAYGILL: I'm sure that is right as a legal proposition. I'm actually making a physical proposition if I can put it that way. The reason why these things needed to be sorted out in some way legally is because the system operator could not deliver on his obligations to everybody else, if somewhere in the system there's a generator and a matching set of consumers who can just do what they like because they've entered into an arrangement they're perfectly happy with as between themselves. The moment we're talking about quantities --

MS BATES: What you mean, it could undermine the system if that happens, but I'm just trying to clarify what the legal basis is to stop that happening and am I right in saying --

MR CAYGILL: At the moment it's connection contracts and under our rulebook it's -

MR WILSON: Under our rulebook if Transpower is a member they will be required to apply these rules against members and non-members.

MS BATES: I get it now, sorry thank you.
MR PALMER: If someone tried to connect unilaterally that would be trespass, that's the other protection.
MS BATES: It's Transpower being a member that's --
MR KOS: Primarily. Then there's the myriad of other contracts that emerge in terms of all the other interrelationships that follow from participation in this interconnected network. It's not just Transpower, it's this whole raft of contracts which are then rationalised into a single relationship.
MR PALMER: If someone can put alternative arrangements in place which satisfy the --
MS BATES: God help them.
MR PALMER: They probably need someone's help, and they wish to resign from this arrangement as long as security and dispatch issues are taken care of, then the resignation would be permitted. Importantly, in contrast to the counterfactual, as well as being a contractual issue here, there'd also be a Commerce Act issue if that resignation wasn't permitted. That protection isn't available under the counterfactual.
MR CURTIN: Just while we're exploring physical arguments, just again by way of information perhaps if you like, just help with this. We do have an image of a national grid as a natural monopoly, if there are any natural monopolies left in the textbooks, but a lot of people I suppose would still point to this one.

I was just thinking by way of analogy with telecommunications where now there are actually competing back bones, if you like, for long haul traffic of telecommunications is it at all feasible to imagine parts of national grid, main trunk, whatever the equivalent of the back bone of a telecommunication would be in transmission terms, actually being open or susceptible to competition in the future?

I'm not sure how relevant this is to point 11 but while it occurred to me --
MR KOS: You've hit on a very popular question.
MR MURRAY: My answer is yes. I think the natural monopoly component is a system operator function, the coordination of the components. The transmission system itself can be owned by multiple parties. The RTO's that have been formed in the United States have coordinated markets against - the PJM is an example, coordinated markets across transmission companies that are owned by different parties. There are competitions now around the fringes for aspects of transmission, through the location of generation and demand options.
MS BATES: There are not going to be two main systems, are they?
MR MURRAY: Transpower is a monopoly, I'm not disputing that.
CHAIR: In other jurisdictions, there are competing groups aren't there?
MR MURRAY: There are competing, it's not necessarily a natural monopoly.
MR CURTIN: But the system operator almost certainly is for engineering reasons.
MR CAYGILL: But even then - that is clearly the case and as far as one might foresee, but one does encounter literature which suggests that as computing capacity and costs alter, it - and it may alter the - I mean it's possible to imagine a foreseeable universe in which even system operation is not done by a single entity, but is perhaps done in a counter-balancing way by a number of entities. I don't want to suggest something that's fanciful, but it's currently a natural monopoly but even then one hears speculation that we may ultimately end up in an environment where that's not the case.
MS REBSTOCK: We're not actually - in the American case there's not actually more than one transmission network in any area, it's just the different segments of it, and in a sense they then become a monopoly in each segment. They don't compete with one another.
MR MURRAY: That is correct. There are elements now of what's called 'merchant transmission' and there are aspects of that in Australia where private

entities are building interconnects in competition with the state owned transmission grid, and there are examples of that in the infancy also in the United States.

MS REBSTOCK: Is that primarily for large business industry players or is that - I mean --

MR MURRAY: It's not necessarily between connecting a single large player and the grid, but can be for an enhancement to the grid. Take the New Zealand context, on a different demand and supply set of scenarios and there were to be built a further Cook Strait cable, another HVDC link; there is no reason in principle why that could not be built and owned by a party different from Transpower.

MS REBSTOCK: Yeah, but in practice, whether it is economical to do, it still determines to some extent whether it's truly a contestable market. I guess the question really is, do you believe the market's contestable? That transmission market, is it contestable?

MR MURRAY: Yes, at the edges now I believe it is contestable, I do not believe that two transmission services whole is contestable in New Zealand, no.

MS REBSTOCK: It's contestable at the edges.

MR CAYGILL: Yes, but I'm not sure what conclusions one draws from this. But if I can give a different illustration, though I very much accept the point that has just been made, the Government policy statement contemplates that the system - no, the asset owner will produce a statement of system performance annually, Transpower has done that once at least and is shortly to produce a second document. That will identify areas where the system is constrained, or areas where security issues suggest further information might be appropriate.

As transmission comes to be defined in service terms, not equipment terms, those needs can be met in different ways and by different entities. It may be only at the margin but it is I suggest a very important developing area that is not at all confined necessarily to a transmission answer, and certainly not to an answer that's always offered by the existing transmission asset owner.

MS BATES: Are you envisaging something that does not involve a link-up with the transmission?

MR CAYGILL: Indeed. Well, a piece of embedded generation must link through the distribution network but might well not be linked directly to the high voltage grid and yet may ease a transmission constraint and therefore be an answer to a capacity issue within the grid.

CHAIR: The combined cycle plants in Auckland are good examples of that.

MR CAYGILL: They're probably linked directly to the grid.

CHAIR: But don't need to be.

MS BATES: But that still links into the grid in some way.

MR CAYGILL: The grid in the very widest sense. If it stood entirely on its own, it wouldn't be a solution to the problem that was occurring in the grid.

MS BATES: I don't want to belabour it, it's just that Transpower would have control over that.

MR CAYGILL: No.

MR MURRAY: As system operator, not as the owner of the transmission grid is the point. It's the system operator function that's responsible for ensuring that those parties that are connecting meet certain technical standards for system security and coordination purposes, and wearing that hat, Transpower would have potentially control of that.

CHAIR: I think the Commission might address the same question to Transpower and see what response we get.

MR KOS: On this particular issue though, probably we're not in a range of difference between counterfactual and application.

CHAIR: We'll perhaps move on, the next one is item 12 which is transitional dispensations.

MR KOS: This has really emerged as an issue in part because of a response, a

slight error that has crept into the draft determination. A number of submissions were made principally in terms of opposing submissions by Comalco, CC 93, MEUG and Transpower, which have submitted that the Commission should make a more detailed assessment of this issue and the general themes that come out of the four opposing submissions were that the dispensation process might be more transparent and subject to greater scrutiny under the counterfactual, and secondly that costs arising from dispensations were likely to be applied equally to incumbents and new entrants. That is to say allocators of the party to the non-conforming plant.

We acknowledge the correct position in relation to TD's in terms of duration, but we submit to the Commission that the real question is, as we put it at B on page 52, why is this not a matter of competitive neutrality between the proposed arrangement and the counterfactual? We say to you that it is competitively neutral that a Crown EGB would be expected to take the same approach to dispensations as the industry body and I'll ask Mr Wilson to address the detailed points in support of that.

MR WILSON: Thank you Stephen. The transitional dispensation regime was developed by the Grid Security Committee through quite an extensive working group process. Now this involved significant debate and analysis between essentially Transpower, industry participants and consumer representatives about how to manage this issue. As Stephen has suggested, we think such a regime would be implemented under either an industry or a Crown EGB. If I can just perhaps depart from the text you've got in front of you a bit and background the issue a little bit first.

Transpower currently includes in its posted terms obligations on all connected parties to the grid to meet certain technical criteria, called common quality obligations in their posted terms. There's a range of plant already in the system connected into the system and operating that cannot comply with those particular posted terms.

Several of those parties for obvious reasons dispute those posted terms accordingly. The system operator continues to operate the system and achieve the standards of common quality despite the presence of those non-compliant assets. If those parties were forced to comply with those obligations, it's been estimated they would need to spend possibly hundreds of millions of dollars to upgrade their plant to meet those obligations.

It's not clear and it wasn't clear to the Grid Security Committee or its working group that that money would be well spent, given that we can operate the system now and meet the performance obligations.

The new rulebook standards are set in a manner appropriate to modern technology. New entrants aren't going to be penalised because they find it difficult to meet the standards. The standards are set recognising their parameters.

We submit that the transitional dispensation regime is an appropriate compromise that avoids spending that unnecessary money, allows standards to evolve as an appropriate response to technology developments without sort of penalising existing players.

MS BATES: Can I just ask you something? The contractual provisions that set the standards which some companies can't meet at the moment, are they higher standards than is necessary for the integrity of the whole system are they?

MR WILSON: By implication yes, because we can operate the system at the moment.

MS BATES: So are there somewhere written are there some basic standards?

MR WILSON: Yes, in Transpower's common quality obligations in their posted terms.

MS BATES: Which are lesser than the contractual terms?

MR WILSON: No they are the contractual terms.

MS BATES: But you're saying contractual terms are over cautious maybe?

MR WILSON: Yes. They're appropriate to new technology and it's appropriate that they be set accordingly, but it's also appropriate that we recognise that some assets have been put into the system.
MS BATES: That will take time to adapt, do you give a time period over which that's to be done or what?
MR WILSON: The transitional dispensation agreement provides for Transpower to set certain conditions and dispensations. They could include a limited duration for the dispensation and if a party goes through an extensive upgrade of their equipment at any point they are then required to meet the new standards at that point.
MS REBSTOCK: Can I just ask you, you mentioned that there was a working party that looked at this issue. What are the options that were considered by that working party? What I'm trying to understand is there must be many ways by which you in a sense fund a transition from one set of common quality obligations to another. You've picked a particular approach to funding a transition. There must have been a range of alternatives that you looked at, they probably have different sorts of efficiency properties.

So, to come to the view that a Crown EGB may take the same approach as this one I'm quite interested to know what the options were, and how the efficiency properties of this compare with the alternatives because the Crown EGB might be guided by the purposes of the Act, and the Government policy statement may follow quite closely certain efficiency principles, that you may not have been able to do, given the relative voting, or the relative representational strength of different commercial interests.

So, can you just take me through what the options were you considered?
MR WILSON: Certainly. They considered applying the new standards against the old plant as one extreme of the options.
MS REBSTOCK: And everyone bearing their own costs?
MR WILSON: Yes and the conclusion was there would be a lot of unnecessary cost incurred and there was a net detriment associated with that.
MS REBSTOCK: What gives rise to that expense?
MR WILSON: They would need, in some cases, to completely replace existing plant, or significantly refurbish existing plant. That was the potentially hundreds of millions of dollars that I referred to earlier. At the other extreme --
MS REBSTOCK: So the dispensation is permanent for the life of the asset you get this permanent dispensation?
MR WILSON: Possibly that's up to the system operator to determine. It could set conditions, including duration, to the transitional dispensation, if it believes that's appropriate.
MS REBSTOCK: So even within the proposal you could get individual parties bearing significant costs of their particular assets.
MR WILSON: Yes, and Transpower in terms of the criteria, or the system operator, would need to assess its decision on a net public benefit basis, so it should make the right decisions, according to the criteria. If I could also --
MS REBSTOCK: Can I just ask you then, given that provision isn't it likely that any alternative the Crown EGB might look at is feasible that the system operator has that within its ambit of choices?
MR WILSON: Yes.
MR CAYGILL: That's our point.
MS REBSTOCK: I'm sorry it's taken me longer to get there but I wanted to make sure I understood why.
MR CAYGILL: We can see no reason why a Crown EGB wouldn't give the system operator the same discretion since we can't find any reason to impose unnecessary costs on people we can't think of a reason why the Crown EGB should do that either?

MS REBSTOCK: But the system operator under the industry EGB proposal does actually have a means to allow these dispensations in a way that allocates the costs, there may be some allocation of costs where individual players bear - because if you can vary the duration of the exemption you can have quite different ways to fund this transition basically, can't you?

MR WILSON: Yes. I'd also like to make the point that Transpower has raised the transitional dispensation regime as an example of anti-competitive rule development. We're somewhat surprised by that because they appeared to support the regime through its development. In fact Transpower was interviewed I think to developing the regime. Transpower's chief executive voted in favour of the regime at the Grid Security Committee, of which he's a member, and they've actually entered an agreement to implement the regime. I quote from that:

"That both the GSC and the system operator recognise the advantages in determining to the extent possible whether asset owners will be entitled to dispensations from compliance with the asset owner obligations when the new rulebook comes into effect".

The agreement establishes criteria as I was mentioning before that Transpower will use to assess applications for dispensation. In particular it says that no dispensation will be granted unless Transpower has a reasonable expectation that will be able to continue to operate the system and meet its common quality objectives.

It's also possible, as I was saying earlier, for Transpower to limit the duration of the dispensation, or apply any other conditions to the dispensation, than it believes are appropriate and any dispensation that they do grant will be transparent to all other parties once the rulebook becomes operational.

So, they should make sensible decisions about dispensations, given that they will be transparent to all parties.

So in conclusion, we suggest that the regime is very well thought out, there's been a lot of work gone into it, will benefit all parties by reducing costs, reducing risks, reducing barriers to entry into the rulebook itself, but because several parties may have had difficulty entering the rulebook without this regime in place and provides appropriate checks and balances.

CHAIR: Certainly, I mean we'll obviously hear Transpower on it but looking at F, on page 52, where you say Transpower doesn't give a reason as to why the Crown EGB would take a different approach, I would have thought that the work done in the GSC and you say there general acceptance, be common sense for both the counterfactual and the application to be pretty similar I would have thought.

MR WILSON: That's our submission.

CHAIR: Obviously Transpower may wish to make some other comments but that letter you quoted from, is that a public document or not?

MR CAYGILL: The transitional dispensation agreement, we'd be happy to let you have it.

CHAIR: Thank you.

MS REBSTOCK: From our point of concern and I'm sure Comalco will let me know if I get this wrong. They have expressed a concern about not knowing until the rulebook is established what the rules might be around this. That then raises questions about how well can we assess what the implications might be for our purposes and I just want to ask you how much - there must be some guidance provided in the arrangements that's proposed to system operator on, or at least some principles on how they would apply the discretion they would be given with respect to these dispensations. Is that --

MR WILSON: In particular, no dispensation may be granted unless Transpower has a reasonable expectation that it will be able to continue - to operate the system in meet it objectives. But there are a set of criteria in the

- set out in the agreement that give us some confidence that they - that the system operator will make appropriate decisions and that will be transparent to everyone at the time the rulebook goes operational.

MR CAYGILL: As to the first point Comalco make about not knowing in advance of the rulebook whether their equipment would comply or not, I'm a little puzzled by that because in fact it's the very reason that a transitional dispensation agreement or arrangement was drawn up by the Grid Security Committee, and negotiated with Transpower and provided in the rulebook. In other words, what we've sought to do is exactly make sure that in advance of the rulebook, and on the assumption that the rulebook is authorised and brought into force, Transpower will now, in fact it's been doing this work for much of this year, entertain applications from asset owners of one kind or another, be they generators or distribution entities or Transpower itself, evaluate the performance, the capacity of the equipment against the standards and work out the appropriateness of indicating that a dispensation would be available. We fore saw the very need that Comalco address for people to know in advance of the rule whether they would quantity.

MS REBSTOCK: So you think they will know?

MR CAYGILL: I don't know whether Comalco have sought a dispensation. They have been - they have certainly been able to.

MR CURTIN: Just if you could help us maybe with the materiality of this, you've mentioned that I suppose for reasons of technical progress new gear can deliver to higher specifications or faster response times or God knows what. I'm just trying to get a feel for how far away say from typical installed equipment. The standards they're operating to, how far away are the current set of standards? You had almost a throw away line of hundreds of millions of dollars worth of assets that could be viewed as legacy equipment, rather than modern equipment, and could you just give us, maybe flesh out a little bit of how far away the latest standards are from typically operating practice today and how much of an issue it is?

MR WILSON: I'm not an expert in those matters and we could get you some more precise information about that. However, I'm informed that it's not a huge range of assets that will require transitional dispensations. It is relatively few. But in a few areas the costs could be quite significant.

MR CAYGILL: If it would assist the Commission we'd be happy to make sure a brief response is made on that.

CHAIR: We'll appreciate that, it will give us just some handle on the actual magnitude of it. Thanks for that, we've got some other submissions and other submitters will put their points of view to us, so thank you for your submission. Moving on, number 13.

MR KOS: Cost of capital which I'll ask Dr Palmer to address.

MR PALMER: In their paper which accompanied the applicant's original application, Murray and Hansen identified the cost of capital risk. That's a risk which arises from the lack of constraints on decision-making under the counterfactual and what's called the associated regulatory commitment problem, the risk that the regulator of the Crown EGB will change course in unpredictable ways.

They presented estimates of the negative impact on asset values with a net present value of 95 it should be million to 240 million using an adjustment to WACC as a measure of regulatory risk. In the original analysis this was presented as an alternative to other more specific measures of efficiency gains. In its draft determination the Commission recognised there was a cost of capital effect, but considered that it was lower than in the Murray and Hansen analysis for two reasons.

First, because the industry would continue to be at risk of political decision-making under an industry EGB structure. Secondly, the Commission were of the view that the risk would apply only to contact and Trust Power, which comprised the majority of direct private ownership in the generation and retail sector.

The Commission's approach was different to the original one, in the sense that they were measuring an additional benefit of the proposed arrangement, rather than being an alternative measure of efficiencies. That approach was adopted in the applicant's submission on the draft determination, but the submission differed from the draft determination, in that it was argued that the base should be wider than just the privately owned companies that I just mentioned. We submitted that ownership does not affect the systematic risk of investment and therefore the cost of capital analysis applies to SOE's as well as private companies.

In their supporting submissions Contact, Meridian and Trust Power maintained that the impact, the cost of capital impact would apply to both private and State Owned Enterprises. The comment included that the Commission was incorrect to exclude MGC, Todd Energy and other private participants in the market firstly.

Secondly they commented that there was a strong body of literature that argued that the value of an asset is a function of the risk involved with it, not of ownership.

Thirdly, they argued that there was no implied guarantees of SOE's by the Crown, and this is evidenced firstly by different credit ratings for different SOE's and I'd submit the Terralink experience from last year. For the detail of the applicant's submissions I'd ask Mr Murray to present our views which are in paragraphs 13.9 and following.

CHAIR: You might cover it Kieran when you make your presentation, but little 2 on the top of page 55, you're talking about an asset value relating to risk that's not ownership. What about the regulatory environment? Is that relevant or not as well?

MR MURRAY: Yes. We think the regulatory environment is relevant, which is our primary point, that under a Crown EGB model there are less constraints on the ability for the Minister to intervene in the industry and that risk of intervention creates a risk for the industry and what we had tried to do in our initial paper was to come up with some form of estimate of what might be the value of that risk.

CHAIR: You'd see that as well as ministerial responsibility as per the Crown EGB model for a more traditional economic regulator, say a US state regulator, you would see that regulation also having impact on risk as well.

MR MURRAY: Yes, we do.

CHAIR: On risk as well.

MR MURRAY: Yes, and in 13.9 on these notes, we refer to our original paper which cited some of the literature, in particular by Professor Spiller at Berkley University, who's tried to evaluate the impact of regulatory risk, and what he terms the credible commitment problem.

CHAIR: Thank you.

MR MURRAY: We in our paper argue that that problem was likely to be higher under the Crown EGB than the industry arrangement and then tried to come up with a means of putting a dollar number on that risk. We said in our paper that we thought our estimate was highly uncertain, but tried to come up with an indication of the significance of the issue. In reply to the various submissions that have been made on this point, we say a number of things. That regulatory risk may impact on systemic risk, that is on beta and hence on cost of capital WACC, if the probability of intervention by the Government or Minister depends on the state of the economy.

However, we think that is unlikely to be a close association with the state of the economy, whether the economy's growing or producing and the intervention. We think it's more likely to be driven by other factors. Hence the risk would be unsystematic in nature and it's likely to be asymmetric, and that is the impact is more likely to decrease a cashflow for an industry participant rather than increase the cashflow.

For those parties who will be subject to this risk. We think it's extremely difficult to make an estimate of that expected value of the decrease in expected cashflow. We therefore tried in our original paper to do what is a mathematically equivalent measure in terms of the decrease in value of an asset. That is to look at WACC. The value of an asset can be determined by the expected cashflow over, equation of the expected cashflow over one plus the return, and so by looking at a measure of WACC, we could use, we use that as an equivalent, mathematical equivalent of estimating the impact on expected cashflow from an increase in regulatory risk.

As noted by the submitters, particularly NZIER there is also scant empirical evidence on that issue. So, we then found some - looked to some US data that looked at the variation in debt ratings associated with different choices of regulatory regimes across states and used that to make an estimate of the WACC of a decrease in expected cashflow from regulatory risk. So, we took what was an estimate of the impact on debt from using alternative regulatory regimes across different states in the US and said let's use that as an approximation of the impact on WACC from regulatory risk and use that as an approximation of what might occur on the impact on expected cashflow, to come up the impact of value.

We noted in our paper that we thought our estimate was, certainly not precise, that was highly uncertain, but that it was an attempt to show the significance of the issue. Therefore, we don't dispute the Commission's judgment in its draft determination of attaching a lower estimate of the impact on WACC than we used. But we do disagree with the Commission in excluding the State Owned Enterprises from the base. We argue that, and we think that's backed up by the capital asset pricing model literature, that ownership is not a relevant issue in determining the value of an asset, and therefore in the revised paper that we've submitted, we have applied the Commission's judgment of the lower value of the impact on WACC against a larger base by including the state owned enterprises in the base.

We did not include Transpower or the distribution companies. Though we make the comment that depending on how the Crown EGB's - depending on how the treatment of the implication of the Crown EGB enforcing a transmission investment on parties is treated on their balance sheets may impact the risk. The point I'm making there is if the Crown EGB were to force on distribution companies to pay for transmission investments that they did not support, and those companies were not able to recover that investment, did not get security of revenue from that forced investment then that would increase their risk and should be factored in. We haven't done that.

The final point I'd like to make in relation to double accounting - -

MS REBSTOCK: Can I just ask you a question on that last point; given part F that could happen under either proposal couldn't it, potentially?

MR MURRAY: Potentially that's correct. There's wider scope for it under the Crown EGB given the --

MS REBSTOCK: I can accept that the scope may be different, but there is scope for it under either proposal?

MR MURRAY: Correct. We believe the Commission's approach in the draft determination does not amount to double counting as NZIER submitted. We see that the Commission's assessments of allocative, productive and dynamic efficiency impacts were calculated as what you might term a certainty equivalent basis and took no account of the higher risk premia and how that higher risk premia may affect actions of industry participant and that the Commission's approach fills that gap by estimating the welfare loss due to increased risk.

So, we support the methodology adopted by the Commission, bar the - we believe that the base should include the State Owned Enterprises as

well as the private companies.

MS REBSTOCK: Can you tell us what literature you're relying on to support the proposition that ownership doesn't matter?

MR HANSEN: Principally a report to the Treasury which we referred to in our submission, that indicated how they ought to be calculated for State Owned Enterprises. I guess to give an understanding of why this might be so, perhaps take a hypothetical example and suppose State Owned Enterprises were in fact Government guaranteed, what would be the implications of that? That would mean that the suppliers of debt capital would be fully guaranteed and insulated from any risk.

But the risk is still there. All that does is shift it on to the equity side. It means the Government would have in that situation just provided a guarantee and the residual - the risk of the cashflows, that that state owned generator faces hasn't gone away, it's just been transferred perhaps from the providers of debt capital to the providers of equity capital which in this case by definition is the Government and that's just as much a loss as if it was a privately owned company.

MR CURTIN: It strikes me that this is something where we could actually get some pretty suggestive factual evidence. One of the things that hasn't been put in front of us and which I'd certainly like to see and I suspect my colleagues would, would be a reasonably comprehensive credit ratings from the agencies of the universe of SOE's to the extent that they have ratings, or if they haven't got ratings perhaps what they're paying for a cost of debt, so we can put them somewhere on a range of actual cost of debt.

MR HANSEN: My last point was really about those credit ratings may not actually reflect it for SOE's. Take the example particularly say of Transpower who runs a very important asset in the economy, transmission grid, I would suggest that there's probably a likely, you know, a higher implicit Government guarantee that no Government is going to allow a failure in that company to the extent that it would undermine security issues.

Some other SOE's that operate more in an open competitive market may have less of an implicit guarantee. So, the comment that Transpower made in their submission for example, they couldn't detect any impact on their cost of capital makes perfect sense from that point of view. But the general point is that I don't think that information on SOE credit ratings would necessarily be useful.

MS REBSTOCK: It would be very hard to pick up this effect that you say, that it's shifted on to the Government's, very hard to estimate what that affect might be.

MR HANSEN: Yes, because there's no market for capital in those situations.

MR PALMER: But the risk is still there.

MS REBSTOCK: I understand the point. I'm just wondering, we're still left with the quandary of how much weight to put on it. It seems to me

MR PALMER: We can assume it would be as reflected by the increase of the cost of capital in the private sector.

CHAIR: I think Eric Hansen's just put his finger on it. Mentioning SOE's in general and looking at question of risk in relation to the regulatory environment, because of the nature of Transpower and the asset they manage or the asset they own, there is an ownership perception behind that. But quantifying it I tend to agree with you, how do you do it? There's a difference between SOE's to some degree depending on the nature of that business.

MR CAYGILL: But there's no difference in the risk that the owner is exposed to, and it's that value that we submit, ought to be taken into account, by the Commission in assessing the impact of the, of the regulatory environment on the cost of capital.

MS BATES: I do understand the arguments put forward, I just want to put a couple of questions to you coming from a slightly different perspective of matters. The risk of regulation on the industry really seems to come

down to whether or not it achieves the objectives of the legislation, or arguably it comes down to whether or not the system that's proposed achieves the objectives of the legislation.

Now I understand that you've said that the Minister may behave in an unpredictable way, but let's assume for the purposes of this argument that the Minister only acts in a way which is consistent with the policy put forward. If the industry is acting in such a way that the minister considers that necessary, then is that a public detriment?

MR PALMER: Commissioner I think the comparison is between, in a counterfactual situation what the Minister might do and the proposed arrangement, not of the Minister interfering with the proposed arrangement and imposing regulation upon it.

MS BATES: The Minister can move in either direction, can't he or she?

MR MURRAY: Commissioner, I refer you to paragraph 165 of our original paper where we attempted to summarise some of the literature on that credible commitment. The difficulty is for many investors who are undertaking investments of 20 to 50 years, is they need to come to some estimate of not only what the current Minister and how he or she might behave, but how future ministers over the life of that asset work. The difficulty is, for the Minister, how to make a credible commitment that they will behave in a predictable and rationale way, and it's the risk that they won't that gets factored into the investment. That's why people look at the hard constraints.

MS REBSTOCK: Does it really change though, given the legislation has embedded in it the possibility any time, and the applicant makes this point repeatedly, any time the Government could make a decision based on, if there was a number of reasons the Government could end this industry EGB and set up a Crown EGB, that possibility is strongly there. How much more certainty from a business - when you look out over 20 or 30 years do you get from knowing right now it happens to be an industry EGB being given a chance to try to self regulate.

How much difference does it make to risk, perceived risk, when it's already the legislative support for shifting to a Crown EGB sits there?

MR CAYGILL: With respect, I think we're making two points. One is whatever that risk is, it isn't a risk which will impact only on the cost of capital of privately owned entities, it will equally impact on the cost of capital faced by state owned entities.

Secondly, as to the nature of the risk it isn't the case that the Minister can, well, the Minister is free to initiate the establishment of a Crown EGB at any time, it's not the case that the Minister can do that sort of, not just arbitrarily but in a, you know in a couple of days, there's a notification process that I think I'm right in saying was actually added by the select committee, not present in the original bill.

So, Parliament with some deliberation decided that the industry should have the opportunity, the public should have the opportunity, to persuade the Minister that it was not in fact appropriate. It's certainly no guarantee that a Crown EGB won't be established, but it is - there is a formal process that needs to be gone through that gives the industry some opportunity to say well, hang on a moment, we don't think you need to do that, let's talk about the issue that has prompted you to signal that thought.

CHAIR: I would have thought you, to be honest, unless the lights go out tomorrow, you're hardly going to get a decision that would change this overnight if this eventuates. It is a question of degree, I accept that.

MR MURRAY: Mr Chairman just come back to Commissioner Curtin. Meridian's submission on page 32 sets out the credit ratings --

MR CURTIN: I've got that open thanks, but I felt that it would probably have been helpful to look at some of the credit ratings just across the range of SOE's. I take your point that the real costs might actually be on equity premiums and that the pure debt ratings may not. To the degree

that there is an implicit guarantee which maybe varies from one to the other, that alone may not pick it up.

Just picking up your point I think another constraint perhaps on the Government changing the rules, later on is that it cannot do that costlessly in one sector without expecting repercussions across the whole range of sectors from overseas investors who will observe takings in one area and demand a premium across all areas.

MR CAYGILL: I think that is - that's a very fair and important point and a point that I know was made with some conviction to the Government during the debate around that legislation, Parliament has given the Government the power to act in this way, but it was certainly argued by a number of internationally owned entities that if powers like that were available, and certainly if they were ever exercised, then there must necessarily be an impact not just in that industry but beyond.

CHAIR: It's fairly logical I would have thought that response.

MR CAYGILL: I don't think that was just advanced as a tactic as it were in relation to the legislation. I think it's true, it's abundantly plain that that is widely believed.

CHAIR: Okay. I think we'll have to go back and rethink the basis on which --

MR KOS: I think Commissioner Rebstock's the comment that's perhaps most caused us to scratch our heads, not to say that other contributions haven't caused us to scratch our heads, but we're still crashing our heads over it, and it's the question of whether the regulatory risk is such that it's effectively the same between the counterfactual and the industry model. I think there might be two answers. James Palmer might put it better than me but I'll have a go. It seems to me that the first answer is that the threat in relation to the industry body is such that the industry body is likely to act to avoid that occurring. That's what it's there for. It's a sanction for conformity to the Government's objectives.

The second proposition is that the providers of capital will be first dated enough to recognise that that is the way in which the industry EGB will behave and so they will assume therefore an enduring industry body because the industry body will act so as to avoid the outcome you're talking about.

MS REBSTOCK: But if everyone out there knows this body's going to act in a way that makes it unlikely the Government will feel the need to set up a Crown EGB it may equally assume that therefore the results may not be all that different between the two, and therefore there's not any difference in risk. In other words, the Minister influences one way or the other. So, it just seems to me that doesn't necessarily resolve this issue about whether there is a real difference. Because in effect you're saying to me well, everybody out there will know it will endure because the industry EGB will do in the industry will do what it needs to do to make sure it does, so it will conform to the Minister of the day's wishes.

MR KOS: That means you end up with effectively two identical outcomes. That's not right. The risk, others can contract to the debate but the risk it seems to me is providers of the capital will recognise a more interventionalist model with the Minister in fact in charge as opposed to the Minister having a power to come into that position but not actually exercising that power.

MS REBSTOCK: I think this comes back to many of the points we've debated. For instance, does - do lenders feel better about having indications from what the Government's position is and the reasons for it in a transparent way, or do they feel more nervous about a Government that influences the development of an industry behind closed doors because the mechanism is through the ongoing threat, that is of regulation, but that is the only way through that tension the Government - and that is not very transparent.

So, it seems to me that we can go back over all of these arguments,

but they all come into play here about your view about whether there really is a difference between the counterfactual and the proposal.

I mean, I accept the explanation you gave is one possible way to look at it, but we just start unravelling all the discussion we had yesterday.

MR CAYGILL: Mr Chairman I appreciate we seem to be circling and coming back to the same point all the time. Can I inject a couple of examples that seem relevant to me. What we're actually trying to do incidentally is illustrate with some specific examples a conclusion that the Commission met, albeit on a preliminary basis and now is open to challenge. I made the point I think at the very outset, that over the last year we have in one sense perhaps been seeing something of the kind of model that might operate under an industry EGB, in as much as the Minister has been engaged in a regular dialogue with the Establishment Committee and indeed with the three codes that contribute to it.

In that time the Minister has, and I gave two instances but there've been more than that. He's identified a desire to see progress on particular issues. It occurs to me to say I have little doubt that had the Minister said I am tired of the time it has taken to resolve the hydro-spill issue, here is the basis on which hydro-spill is to be disclosed, we would have ended up with a different outcome as to the detail as compared to what actually happened where the Minister said I would like you to seriously address this so the industry went away, debated, and came up with a common basis of disclosing. I can't prove that because we don't have that counterfactual but I am confident of it.

The second instance I think I can - I think the proof is plain. In relation to bids and offers where the Minister said please address this, the codes have done that but we do have a different outcome agreed to so far by NZEM and now a refinement of that to be considered again by the Commission. Those positions are different from the position that was first adopted by the Government itself in its draft policy statement. So, where the Minister says here is a topic, here's an outcome I'm looking for, please go away and address that, let's negotiate a performance target that says you will do so, there is reason to think that the detail that emerges may well be different from the detailed position that is adopted if a central agency simply says we wish to see this addressed and thank you for your submissions, here is the answer.

CHAIR: Look I certainly hear what you say. I mean the point you made yesterday, the way this iterative process has been communicated to the Minister as you work through it, and I think the Commission will have to have a look at this one because I'm not too sure whether we're agreed on the response to your submission anyway. But your point's taken.

MS BATES: I'll just make sure I've got it quite clear. It seems to me on one model, the decision-making power's in the industry, and on the other model the decision-maker's power in the minister, and it's quite clear from the industry's perspective there's less risk of adverse decision-making when the industry is in control?

MR CAYGILL: I don't think I would use the word 'control'.

MS BATES: It has a decision-making power which is subject to the minister's overriding ability to set objectives, outcomes and do some monitoring. It's quite clear on a simplistic way of looking at it that the industry's likely to get decisions which it prefers under the industry model.

MR CAYGILL: Yes, I think we do agree that's --

MS BATES: But the risk - I'm just summarising here - the risk to the industry comes in where it's not meeting the objectives as set by the Minister I think.

MR CAYGILL: I'd see it actually as risk to the country.

MS BATES: Yes, but if we're just talking about the risk of an adverse decision which impacts on the value, yes, I think the risk does come in there.

MR PALMER: That's right. So there are risks in either scenario but they're on

different points on a continuum. On the one you have got what the industry has to do to get the minister off its back and avoid the threat of regulation versus at the other end the Minister being the end decision-maker.

MS BATES: But of course what the industry has to do to get the Minister off its back may well mean less return and therefore adversely affect the value of the assets.

MR CAYGILL: Indeed, but the precise place at which there is a landing, the precise way in which bids are disclosed, may not be the same if on the one hand a topic is identified, please address this, or on the other hand a precise rule is formulated. Had the Government mandated the disclosure of bids at the point when it first raised that issue, we would now have a different basis for the basis resolved by the industry. I'm not arguing that actually one is preferable to the other. I'm using that as a real example of a different outcome. All I can say is it seems pretty obvious the place were the industry is landed is one that it is relatively comfortable ones.

The minister hasn't suggested that's not good enough, that's not what I meant. So, there is a difference that looks as though it will ensure --

MS BATES: His is an industry, world wide it's subject to regulation or subject to Government taking some sort of interest in it. So, anybody who invests in that sector knows that.

MR CAYGILL: Yes, and we conceded, indeed pointed to the tension between self-interest and Government involvement.

MS REBSTOCK: Can I just ask a question, do you think we can assume that for the life of this arrangement that ministers will always choose to exercise their influence in the manner that this Minister has been doing?

MR CAYGILL: No.

MS REBSTOCK: Because there is a real possibility isn't there that that could change and could lead to quite different outcomes.

MR CAYGILL: And the nature of the statutory framework can clearly change. That must be the case. However, it seems to me that we can only evaluate what we have in front of us in that regard. If we start to say well where might an industry arrangement go if there was a change of regime or where might a Crown EGB if the law was different.

MS REBSTOCK: No, I'm asking the question, we cannot assume that the interface with the industry EGB via the Minister will have the same dynamics that it currently does. We can't make that assumption do you agree?

MR CAYGILL: No, and I don't invite the Commission to make that assumption. I wanted to use what has happened over the last 18 months because I think it in fact does follow the language and processes contemplated by sub-part 2 of part 15.

What the Minister has specified in the policy statement is precisely outcomes that he has been looking for and indeed performance targets in the sense that time frames have been discussed. So, those are precisely the kinds of intervention that are available under the Electricity Governance organisation model and while a different Minister might have picked different topics, a different Minister would have been obliged, will be obliged, to use the powers and only the powers that are available under that subpart. It seems to me the ministerial behaviour over the last 18 months has precisely married the powers that Parliament has given in relation to an industry EGB.

MR KOS: There's a second answer too isn't there, which is a change of political complexion is likely to pick up the continuum James was talking about and shift the entire continuum in one direction or the other.

CHAIR: I think I'd like to draw this to a close. I think we've had a very extensive debate on it. I think the Commission has some, obviously matters to consider. I wouldn't like to second guess any more change in ministerial view or whatever. I think the points have been very well

explored. Well, are Genesis here? Right. If we can adjourn and start with Genesis at quarter to 4 and ask EGB to be back around 4.30, giving us 5 minutes for a cup of tea and if Genesis can make their submission, at around 4.30 EGB will come back again.

(Adjournment from 3.40 to 3.45 pm)

SUBMISSIONS BY GENESIS

CHAIR: It's now 3.45. Genesis, welcome. Thanks for coming to make your submission on the application. Perhaps you could introduce yourselves to start with, then it's over to you. I'd like to be as informal as possible. If you think any of us are asking questions that are way off beam please say so, because that's what you're here for. So, please let's start.

MR CARROLL: Thank you, and thank you for adjusting your schedule to take account of those of us not fortunate enough to live in Wellington.

CHAIR: You said it.

MR CARROLL: My name's Dean Carroll, I'm general manager of generation and trading for Genesis Power. I have with me on my right Wayne McCrean who's a wholesale manager and on my left is Anna Gunn, who's our corporate counsel.

Our perspective is probably different in a sense that we are speaking really as an active market participant. We run all our electricity sales and purchases through the New Zealand Electricity Market and pay fees on all those quantities in contrast to some who choose to trade outside the arrangement.

So, what the arrangement does and the costs it incurs bear directly on us and we have a considerable interest in those arrangements. We have made a submission, we don't intend to read that to you, and we are here in support of the applicant, so don't see merit in traversing ground you've already covered.

So that left it to us what could we do from that perspective. We felt that, in reading through our submission and other submissions, that there were some points we wanted to make. We wanted to address the issue of pro-competitive rule changes. Those of us who sit on working groups, and both Wayne and I are on and have been on several, take our responsibilities seriously. There have been some very strong serves from some people submitting on this application to the effect that pro-competitive rulebook changes are not treated well, are unnecessarily delayed, and that the arrangements are not robust.

We would, although we've mentioned them in our submission, we would like to speak to some of the rule changes that have gone on so that the Commission is aware that market participants do incur costs, decrease their wealth as MEUG have raised as being a metric of a pro-competitive rule change. Whether I agree with that or not we are impacted by these rule changes and we'd like to work through a couple them and talk around them a little bit from a practical point of view.

We also want to look at the effect of self-governance versus the EGB may have in regard to some of these rule changes, and the environment that we do business in, where we currently are contemplating a half billion dollar investment in a CCGT, combined cycle generation plant at Huntly, and obviously a regime, the rules under which it will be dispatched are very interesting to us and the stability of those going forward. We will address section 30 and Anna will talk to the application and we'll talk a little on our future needs perhaps. If you want to take us anywhere else then we can go there.

If that's acceptable to you, we could talk a little bit about some of the rule changes that we have proposed.

CHAIR: That's fine. I think also on that point, not only rule changes that

have been adopted, but if you feel there have been pro-competitive initiatives in the rules that have not been adopted or blocked, so there are sort of too sides to it if you like.

MR MCCREAN: If I can just first of all help set the scene by introducing my background and also talk a little bit about the characteristics of the wholesale market. I have ten years of experience in the electricity industry, mostly in New Zealand but also some time in the United Kingdom. So, I have experienced both light handed regulation and also a formal regulation environment. I've worked in the coal face of electricity production, transmission, market development in 1996, the rulebook evolution ever since.

I currently run our wholesale trading team and look after the commercial arrangements for connection transmission common quality. I've contracted to many working groups over the years and like others in our company, and in other companies in the industry, commit a lot of effort and time to industry development. Working groups that I've been involved in include the NZEM Market Information Working Groups, Market Pricing, the NZEM and MACQS Relationship Working Group, the Loss and Constraint Allocation Working Group, and three of the working groups that led to the formation of MACQS, over the last four or five years.

Electricity markets are complex and they are expensive to run. I think that needs to be acknowledged up front. There are reasons for this, as follows. There are no, or there is no other product in the world that is the same as electricity. Supply and demand must be balanced in real time. It cannot be stored, you cannot track the electrons of one party to another and hence the concept of having an electricity pool and requiring reconciliation rules. Common standards are needed as the behaviour of any one participant can impact on all others.

Assets have long life times and large capitals involved in those assets. The value of non-supply is incredibly high.

The industry is aware of these complex issues and is very well informed of them and most companies in the industry commit substantial resources internally to be able to contribute to market development, rule formulation. To those that are standing outside of the market it may appear that, well for those standing on the sideline, it can appear easy to poke a stick at the likes of the NZEM, and say that it is ineffective and slow to implement rule changes, but I think as I've just covered the issues to be dealt with are very complex, and they at this point clearly have a lot of implications.

So, we see that it is not surprising at all that some rule changes have taken the period that they have to be carefully assessed.

Two areas that we'd like to talk about, first of all the efficiency and decision-making of an industry body in comparison to a Crown EGB and secondly, the pro-competitive rule changes.

The NZEM being an industry, a multi-lateral contract, we believe has had a track record of efficiency and decision-making and implementing pro-competitive rule changes. As has been stated in the EGBL submission there have been 27 pro-competitive rule changes in the NZEM and a further seven are in progress currently. I'd just like to go over some of the key rules we think that have been implemented, that have definitely been pro-competitive.

Firstly, in 1997 the reduction of what's called the "four hour rule" down to the "two hour rule" which is a fundamental rule in terms of gate closure time in the market. That rule required lots of consultation, especially with the grid operator to ensure security of supply was not going to be at risk and the rule was passed.

Second rule change also in 1997, dispatch prices were introduced. Dispatch prices are based on a forecast that is produced by Transpower and they're a very short-term price forecast that the market has used to

give more accurate signals. That has helped improve consumption and production decisions in real time. In 1998 next day final pricing was introduced. Prior to then the market had to wait a month before it knew the final prices and that was such a long period of time to wait there was obviously uncertainty as to what the price was and the potential for inefficient decisions.

In 1999, a rule change came in that enabled small generators to have special, well, to not have to comply with the full set of offering rules. So, that's an example of where the barriers to entry were lowered for smaller players in the market.

In 2000, constrained on payment, a rule change came through which eliminated the possibility of generators to receive constrained on payments if they generated when they hadn't received dispatch instruction. That was supported by all generation class market participants.

MR CARROLL: All of whom, I might add, did prior to that receive payments in the absence of dispatch instructions. So, this was a situation where there was a reduction in the collective wealth as MEUG put it.

MS REBSTOCK: So, it was not in your commercial interest to agree to the provision?

MR CARROLL: Not it was not.

MS REBSTOCK: But you all agreed?

MR CARROLL: Mmm.

MS REBSTOCK: Why did you agree?

MR MCCREAN: It was consistent with the guiding principles of NZEM that improved efficiency in the market.

MS REBSTOCK: What sort of cost would you have borne as a result of that?

MR MCCREAN: I don't believe we would have incurred too much cost because as a company we didn't have a policy to be generating when we hadn't received dispatch instructions.

MS REBSTOCK: So it wasn't actually not in your commercial interest?

MR CARROLL: There were times that we would be in that position of ramping down and getting the constrained on price.

CHAIR: Presumably other generators would have benefitted or some would anyway.

MR MCCREAN: The opportunity was there within the rules if they wanted to.

MR CARROLL: If we wished to take them.

MR MCCREAN: The final one was, real time dispatch was implemented in 2001 which didn't actually require rule changes in the NZEM but it did require Transpower to achieve the buy-in from generators because it subjected generation plant to five minute dispatch instructions rather than half hourly. That was quite a major change because an asset such as Huntly Power Station, a typically large thermal plant is designed to be operated where it's not receiving frequent changes in load, where this rule change suddenly meant that every five minutes the potential was there for changes.

We supported that rule change because we saw that it opened the window to move to real time pricing which, if I can just move on to real time pricing which --

MR CARROLL: Just before we leave real time dispatch though, you should be aware that four large thermal operators, and really there's only ourselves and Contact, it did cause the operators of the plant considerable distress to find they'd be feeding more fuel into the boilers to ramp units up, and could five minutes later be asked to run-down and it's a difficult thing to balance the units under those conditions. It increases their wear. We've modified our operating practices to do it, but it's not the way those plant were really designed to run. But it does facilitate real time final pricing, which was regarded as being again inconsistent with guiding principles, and a worthy objective.

MR MCCREAN: Just on real time pricing that was first proposed in 1998 and possibly earlier, but from our records we couldn't find any earlier

dates. In 1998 Transpower advised that due to security implications they would not permit the change at that time. Later on in June 2000 the Rules Committee subsequently asked for the, a fundamental review to look at moving towards a real time market and then last year real time dispatch was implemented which has now set the scene to enable the next move to real time pricing, which in the last few months has been signed off by the Rules Committee to move towards a trial phase.

So I guess the purpose for going through all those was just to explain and describe some of the rule changes that have occurred within NZEM. The issues around all of those rule changes were complex. There were a lot of implications of them, lots of new rules needed to be drafted and they have been completed.

MR CARROLL: So I think the point --

MS REBSTOCK: Can I ask you just one question. Does your SOI - SCI - sorry, I was confused who has an SOI or an SCI. Does your SCI put any requirement on you with respect to how you will meet the public interest in terms of the governance regime?

MR CARROLL: I don't believe there's anything that explicitly relates to these issues.

MS REBSTOCK: So when you're on a working party, I mean it's quite useful to be able to ask you questions with your experience on working parties. When you're on a working party, how does Genesis approach that? Are you there to represent the interests of Genesis, and how do you decide when you're going to progress things based on the direct commercial interests of Genesis as opposed - as compared to say possibly doing something in contradiction to that commercial interest and perhaps - but may nevertheless be to the common good of the industry, as you put it?

MR CARROLL: The working group members are appointed, and we firmly support this, for their expertise, not to represent their companies and our observation of working groups from most participants is that they have been - members of working groups typically have respected that.

I would view Genesis' long-term commercial interests to be best served by a robust dependable market that we could rely on, and rely on to follow due process so that knee-jerk reaction as to what seemed like a good idea, nevertheless have to go through due process and what appears to be delays externally can also be viewed as good governance at work.

MS REBSTOCK: So when you look forward to the arrangements that have been proposed you will continue to work on working parties, probably on the same basis. When it comes down time to vote on proposals, will you approach it on that same basis?

MR CARROLL: This is in respect of a future, with a - the future, whichever regime?

MS REBSTOCK: Under an industry EGB?

MR CARROLL: I would see the performance of individuals on a working group being the same. I guess the influence of that working group and its recommendations may be different, depending on whether it's the Crown EGB but the working group itself I would imagine, I would hope, behave in the same way.

MS REBSTOCK: And do you think that when it comes time for Genesis to vote on the proposal at that point will Genesis take the same sort of long-term view, or what happens when you're faced with a proposal that has a significant financial cost to - when it comes time to vote? I understand on the working parties you're there as an independent, for your expertise, but when Genesis comes time to vote as Genesis, then what guides - what would guide the voting behaviour of Genesis?

MR CARROLL: The voting behaviour has been based on the merits of the case. Significant long-term --

MS REBSTOCK: Merits in what sense?

MR CARROLL: In terms of its fit with the guiding principles and also - a lot of these rules actually are reasonably operational in their nature and come

down to considerations of what is practical to implement as well, and a real time dispatch is very much like that where plant was being thrown around in a way it had never been thrown around before. That is the advantage of working groups at that level, they can bring those considerations to bear.

MR CURTIN: Just you may have heard there was a wee bit of discussion earlier about the industry's difficulties in getting to the point of publishing offer price information and I just wondered if either of you had been involved in those debates and what your perspectives were on the difficulties, the industry seemed to have with the idea of publishing the offer prices?

MR MCCREAN: Yes, I was involved in the market information working group. I can't remember exactly, it must have been three or four years ago when it was looked at. My memory's a little bit sketchy but I recall there was fairly robust debate on the pros and cons and advice was obtained, and two sets of advice were obtained that were basically at 180 degrees to each other, which didn't help us at all. We asked the MSC for their view on it, which was I think in 1997, and they ruled that that information would commercially disadvantage some market participants and therefore should remain confidential and not be published. So, at that time the rule change proposal was left and, yeah, subsequently been picked up again.

CHAIR: Resume, please.

MR CARROLL: I don't think we need to go through more examples.

MR MCCREAN: The removal of demand bids is another one that we could talk to if you like.

MR CARROLL: It has been raised that was something that was delayed by the market.

MR MCCREAN: Some of the background around why that has been such a complex issue and hasn't moved forward rapidly. Demand bidding is part of a - is one part of a much bigger issue and it's really all part of the issue of price discovery leading up to real time and on one hand the suppliers are wanting some information the day ahead, so as to be able to start making commitment decisions with thermal plant, hydro plant.

Currently with the demand bidding arrangement, suppliers obtain that information by the bids that have been put into the market and that's - we don't receive other information from the market until these dispatch prices which Transpower as a good operator publishes close to real time. So, we rely very heavily on the demand side bidding information to help us make decisions with our plant a day ahead.

We do acknowledge that the demand bidding is not as effective as it could be, because its participants are having to forecast demand when they may have customer bases spread throughout the whole of New Zealand. So, it's not perfect. We're supportive of it being reviewed and coming up with a better solution. We were concerned by some of the issues people have raised, that they've hit a brick wall with this proposal. There have been requests just to stop demand bidding and replace it with a Transpower forecast. That to us sounds a little bit - it's a very rushed decision because at the end of the day there's got to be some sort of good information out there for decisions to be made and the incentives have to be in the right place for those decisions to be made well.

MR CARROLL: I think though to put it in a broader category, this was most recently raised during the rationalisation working group by Comalco. Comalco don't actually bid into the market, but that's another issue. At that time the rationalisation working group was busy putting together these arrangements that are before you now. It was a big job. This particular issue wasn't regarded as something that had to be decided right now.

I think merit in mentioning it, is that it's easy to raise these things and for them to get traction and there's merit in the governance

board being sufficiently close to be able to make judgments about what should get traction and what shouldn't and I guess a concern for us is that when - as that say, as that governance moves further from an industry board to an EGB with significant influence from ministers that people will be less able to make good judgments about what should and what shouldn't get tractions, what's big, what's small, what's vexatious, what's not. It gets more difficult, as we look to invest in this market we need to have confidence that those decisions will be well made.

We don't raise the performance to date as being a guarantee that that performance continues into the future, but we think it is material and it's important to counter the criticism that has been made of it.

CHAIR: Just be more specific on that. Performance in what? You said performance to date.

MR CARROLL: The performance of the market I think in passing pro-competitive rule changes. I am conscious of time. We did want to speak to section 30. If you're happy to move on we could move to that.

CHAIR: Yes, this is the price fixing section of the Act, and the points in our draft determination, please.

MS GUNN: My name's Anna Gunn and I'm part of the in-house legal team that we have at Genesis. I really just wanted to raise this issue and in particular our support of the submission by NZEM. As outlined in our written submission we do support the submission by NZEM in relation to the relevance of recent case law and decision 280 to the Commission's determination of whether or not the price mechanism in the rulebook breach section 30 of the Commerce Act.

Genesis has actually sought its own external legal advice which supports our view and endorses the submission prepared by the solicitors for the Rules Committee of the NZEM for the reasons given in that submission and I will summarise.

CHAIR: Would you be able to let us have a copy of that. You can send it down if you don't mind forwarding it to us

MS GUNN: Exchange that.

CHAIR: We can probably circulate it to other parties so that everyone knows what's in front us, if that's all right

MS GUNN: I'll have a chat to --

CHAIR: We'll leave the request with you anyway. If you could, it could be on the understanding that we would circulate it to other parties so they see it. Thank you.

MS GUNN: As the Commission stated, in decision 280 the Commission at that time determined that the NZEM electricity pricing mechanism similar to those now proposed in the rulebook were not in breach of section 30 of the Commerce Act. While the Commission in its draft determination has acknowledged the similarities between the NZEM pricing mechanisms and the mechanisms now being proposed, the Commission has indicated a preliminary view that recent case law may have actually challenged the validity of the application of the previous analysis of these pricing mechanisms in that decision 280 to the current application.

The cases referred to by the Commission as usual dealt with specific facts and issues, but it's Genesis' view that the findings in the case do nothing to justify any change to the analysis in decision 280 relevant to the pricing mechanisms now being proposed in the rulebook. In particular the recent cases that the Commission has discussed in its draft determination establish the following point.

Point 1: Being the competitive effects of an arrangement is not relevant to whether or not it breaches section 30, and;

Point 2: It is not necessary to show a fixed price or agreed discount in order to establish price fixing, but rather merely that the arrangement controls price by exercising restraint or direction upon the free action of our wording market participants.

It's Genesis' view that in establishing point one, the cases, the

recent cases have merely confirmed the intention and effect of section 30, which was not disputed in decision 280. In establishing point two, the cases provide additional guidance as to the sorts of arrangements which will fall within the ambit of section 30, but do not imply that the pricing mechanisms considered under section 280, and now proposed in the rulebook, should be deemed in breach of section 30.

It's our interpretation and view that decision 280 recognised that section 30 is a deeming provision and utilised the same definition of control he referred to by the Commission and finding that the NZEM arrangement did not restrain a freedom that would otherwise exist as to the prices to be charged.

Genesis endorses NZEM's position that the mechanisms proposed in the rulebook to determine price does not control the prices but merely act as a mechanism for the market to freely operate and thus set prices in accordance with the forces of demand and supply. Now the evidence of this proposition is the fact that the prices would be the same if the market did not operate through this rulebook mechanism. If the market process and prices would be the same without the mechanism, the mechanism cannot be said to be restraining or direct in the pricing.

This proposition is submitted in analysis of whether the rulebook mechanism restrains or directs price. It's not submitted in argument of the actual competitive effect of the mechanism. There is no inconsistency between testing whether a mechanism controls prices and the Commission's position that questions of whether or not there is in fact a substantial lessening of competition caused, are irrelevant to whether or not section 30 has been breached.

MS BATES: Ms Gunn, could I just ask you to clarify something for me. Is it your submission that you look at whether the prices would be the same with or without their mechanism or are you saying that's what the Commission think?

MS GUNN: It's our submission that you can't say that the mechanism is controlling the prices, if without the mechanism the prices would be discovered in a similar way.

MS BATES: In the examples that we're specifically looking at, do you think the prices would be the same, whether or not there were those mechanisms?

MS GUNN: It's Genesis' view that what the mechanism does is actually provides a market to allow discovery of the price.

MS BATES: I understand that, but is it your submission that the prices would be the same whether or not these mechanisms were in place.

MS GUNN: Yes, it's a mechanism to discover the price rather than to set or control.

MS BATES: So if there was no mechanism the price would be identical.

MS GUNN: Yes, but what the mechanism does is allow the market to discover the price - that market might not otherwise be there if --

MS BATES: You're saying if there's another set of arrangements, the price would be identical?

MR CARROLL: Our view would be that it would be because the assets we are prepared to make available, we make available at a price. If that price is not exceeded, the assets aren't deployed. We assume other people have the same attitude. So, for demand on a specific day it will - price discovered would be the same. We don't believe that people change their behaviour because of the mechanism. We think the mechanism, as Wayne alluded to earlier, we believe is necessary because of other things, such as preserving security and quality.

MS BATES: Are you saying the price discovered doesn't influence what you would price at?

MR CARROLL: We make available our assets at a price. If that price is not achieved they won't run.

MS BATES: Yes, but don't you have regard to the indicative price? Don't you have regard to what the price found is in setting your price?

MR CARROLL: No, we don't. I mean we make our assets available based on a number of concerns.

MS GUNN: The conclusion really, because of the reasons that I've outlined to you today, and those which are drawn on the detail in the NZEM submission, we as Genesis support the NZEM submission to the effect that the submission should not depart from its analysis of the pricing mechanisms now being proposed which it - the analysis that it followed in decision 280 we feel is still valid.

CHAIR: I'd written down I think that the outcomes in relation to prices I think you said are the same. The outcomes were the same whether the rulebook was applied or not I think is the way I heard you, which is a similar point to one Ms Bates raised. Can you give us any information or evidence to support that, because it is fairly critical to the points that were made to us yesterday. I mean I accept that the rules are there for dispatch purposes for security purposes and so on, but can you show empirically, that if those rules weren't there - just assume you're trading Coca-Cola or whatever, or hog features, you would still get that same price discovery outcome.

MR CARROLL: The perspective that we have would be that looking solely at our own plant, irrespective of the price setting mechanism, if we don't get paid the price we determine we need, we don't dispatch, we make the assumption other folk have the same view that they determine what price they require, that's the price location volume triplets they make available to the market in their bids. If there was only - if our plant was the only plant on the system we only had one tranche, and it was at $50, if we weren't paid $50 we wouldn't dispatch. Whether we were paid it through the NZEM or another mechanism we would still require $50 to dispatch as an example.

As more players are involved there are more offers made, but the principle we believe remains the same, that each one of those players will require that minimum price.

CHAIR: As a price below which you wouldn't dispatch.

MR CARROLL: Below which we won't dispatch.

MR SKELTON: My name is Ben Skelton. I'm in the Legal Services division of the Commerce Commission. Just following on from what the chair has said, if you're saying that prices would be the same, irrespective of the wholesale pricing mechanism, does that mean that if the Commission discovered that prices were different, then that is a breach of section 30?

MR CARROLL: I can't say.

CHAIR: I'll leave the issue with you. If there's any more information you could let us have, I think it would be useful when we have to sit down and work through a response to submissions made on section 30. As you will have guessed, there were submissions made by EGBL on it. You put a slightly different perspective on the way it operates which I think is important. I presume your statement is available anyway Ms Gunn, so if it were be possible to have the other legal opinion you mentioned, plus your statement and if there's any empirical evidence on a completely neutral market as far as rules are concerned, but trading electricity, assuming the dispatch and other rules are not there for the purposes of argument, it would be really useful I think. If you can't you can't. We would circulate any comments from that perspective to other parties as well.

MR SKELTON: One more question. Did Genesis have an opinion on how the transmission pricing and cost allocation procedure - how that was affected by section 30?

MR CARROLL: No we don't, we refer to EGBL.

MS REBSTOCK: I just have one issue I wanted to follow-up with you and give an opportunity for you to comment on. Both Meridian and the applicant have in response to a question from the Commission about possible conditions

that could be applied, should the Commission be of a mind to authorise the arrangement, I wondered if Genesis wished to make any comments on the conditions which have been suggested to us?

CHAIR: By the applicant.

MR CARROLL: Could you confirm what the conditions are?

MS REBSTOCK: In the case of Meridian they relate to part F and they - I need to be responsible for, and I apologise for paraphrasing them but they relate to additional pricing principles, additions to them.

MR CARROLL: We can't comment on those off - we could come back on that.

MS REBSTOCK: And the other conditions you may be aware of, are you aware of which conditions the applicant has suggested if --

CHAIR: They were circulated on Thursday. We could give you copies of those if you haven't got them up there.

MR CARROLL: We could probably write back to you on those.

CHAIR: Could we have a response, if possible, fairly early next week so we can circulate them to parties and the parties have a chance to make any further comment. I don't want to have sort of two conferences if I can avoid it. But they would have been sent to Genesis last Thursday wouldn't they. So, they'll be up there.

MS REBSTOCK: Just one final question, the applicant has suggested that we extend the scope of the application to include an explicit authorisation of the voting structure, and again I'm sorry that I'm paraphrasing, and I wondered if you had any views on the appropriateness of us considering extending the scope of that proposal at the point at which it has been put to us to do so?

MR CARROLL: We'll come back with a comment on that as well.

CHAIR: Thanks for coming down to let us have your views and any further information you're able to let us have will be appreciated. But we obviously take all these things into account and will be looking to make a determination some time in July. But thanks indeed for your involvement.

MR CARROLL: Thank you.

CHAIR: We'll resume in five minutes time if EGBL is willing. Thank you.

(Adjournment from 4.30 to 4.35 pm)

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CHAIR: According to my list we're on to number 14, Mr Kos please.
MR KOS: Dr Palmer is on this one sir, so I'll pass it over.
MR PALMER: It's the start of the home straight.
CHAIR: There's still a hurdle there though.
MR PALMER: We're only about an hour behind where we expected to be yesterday.
MS BATES: Catching up fast.
CHAIR: I hope it's a flat race and not a steeple.
MR PALMER: The applicant in its original application as clarified by its letter to the Commission dated 5 February of this year, has sought authorisation for seven sets of provisions. There are two issues which arise from the submissions on the draft determination and subsequent correspondence. I'm at page 58 of our notes. The first issue is a suggestion by Transpower that it may be that the Commission look to authorise the rulebook as a whole, rather than the particular identified sets of provisions.

The applicant does not seek to change its application in this regard for two reasons. The first is that the - we feel the current application is more in conformity with what is expected by the provisions of the Act, that is that sections 58(1) and 58(5) refer to their entering into a contract arrangement or understanding as a whole so that's applied for, but sections 58(2) and 58(6) refer to the giving effect for particular provisions. It's because of those subsections, that is we've identified the particular provisions for which we seek authorisation.

Secondly, it's the applicant's preference not to extend the application in that regard because it perceives it will have more flexibility to allow the rulebook to evolve over time if the authorisation to give effect to the arrangement covers particular sets of provisions rather than the rulebook as a whole.

The second issue relates to a requested extension of the application. This was set out in our submissions on the draft determination at paragraphs 10.3 and 10.5. In those submissions the applicant noted that given the Commission's view as to a possible detriment stemming from the voting arrangements, there would be a risk, if the authorisation was not extended, that an opponent of the rulebook could challenge the proposed voting arrangements as substantially lessening competition, and that even if the Commission was in favour of - found that there was a net benefit for the arrangement and was in favour of granting the application, then unless the application of the authorisation was extended, it would - the arrangement would still be challengeable.

It is submitted that the amendment is of a minor nature particularly given the way that the Commission approached the analysis in the draft determination with a focus on the voting arrangements and the competitive effects of them. We feel it can't come as a surprise to have a request to extend the application in this regard, and certainly the interested parties have been focused on these issues by the draft determination, so they should be prepared to make any submissions on them.

CHAIR: Thanks very much. I guess on your last point as I understand it certainly at least one submitter is not opposed to that extension that you mentioned. Obviously we'll hear submissions from others as we work through. So, that will be picked up as part of the process.

Secondly, in relation to the rulebook as a whole or what has been requested, was there much discussion of that issue in the working parties that lead up to the application?
MR PALMER: Within the applicant's internal decision-making processes that resulted in the application, attention was consciously turned to that

decision and it was a conscious choice to approach it in that way.

CHAIR: I think that seems to take care of that one. But as I say it will be raised again by others, in particular that last point. I'll be asking them if they think the notice and time for us to make a decision on it is appropriate apart from the issue. Okay that brings us forward to the amendment process I think, which is number 15.

MR PALMER: The Commerce Act in relation to authorisations doesn't set out an express scheme for what happens after an authorisation is granted. If the contractor arrangement is modified subsequently in some way. By implication section 65 is relevant which deals with changed circumstances, and also part two remains relevant to any changes to the arrangement. In order, however, to produce a degree of clarity or certainty for the applicant in dealing with future rule changes we have set out in paragraph 10.5 of the submissions and in page 59 of these notes a rule, a process or a test which we think reflects part 2 of the Act and section 65 which the applicant would use if given an endorsement by the Commission as its guideline for judging whether or not a future rule change would have to go back to the Commission for a further authorisation.

CHAIR: I might ask the staff, what's our practice been in previous situations like this, have we had any?

MR TAYLOR: I'm not sure we've ever addressed it in this way on any previous decisions.

CHAIR: The second point, we'll have to think about it obviously. The question I would ask, if the Commission were to include such a clause in its determination and I say "if it were", that would not take away from the EGB, as it will be if the thing is authorised, where any anti-competitive rule changes may take place, you'd still want to come back for authorisation if necessary.

MR PALMER: It's purely to clarify around the edges of that when a rule change would or wouldn't have to go back. It certainly wouldn't replace the Act and it certainly wouldn't avoid the need to go back if there was a rule change which breached a provision.

CHAIR: The onus would be on you to make that judgment.

MR CAYGILL: Absolutely. If the Commission forms a view that it can't do this, or it's not prepared to do it, so be it. It frankly, I don't think it would be any surprise that there might not be a precedent for it. This is, I suggest, a relatively unusual situation.

CHAIR: That's not the question.

MR CAYGILL: It might have arisen in the context of NZEM, except NZEM didn't require authorisation for reasons that are not available to us. What we can see clearly is the plain need, I'm tempted to say frequently, but let's not go there, to amend the rulebook. On page 60 we identified just a couple of examples that we know are already in train.

Mr Alexander mentioned another one this afternoon. NZEM are already addressing a change in relation to the - moving from a half hour to a five minute time period. It will make no sense for the market to go from five minute pricing back to half hour pricing, merely because we've only - we had half hour pricing in our rulebook at the end of last year. At that point, so did NZEM.

So, there are a number of areas where, without any extension of scope, plainly amendments will be needed, we're simply saying if it's open to the Commission to confirm what seems to be a reasonable approach to us, or to lay down some other approach, that would be extremely helpful, that's all.

CHAIR: We'll consider it. Others may wish to make comment on it.

MR CAYGILL: Indeed. Partly because we've raised the issue in this way so that others can make comment on it, it's a matter of which they've had notice.

CHAIR: I'm sure they will. Okay, thank you. Let's move on to number 16.

MR KOS: This issue arises from submissions from Comalco. This is the question

of impact on long-term contracts, number 16, and the letter attached to their submissions. It's a curate's egg of a letter, because it raises a number of points that actually are very helpful in relation to unpredictability of investment decisions under the alternative model. So there are bits we rely on. We have to address in this part squarely the matter they've raised in relation to the impact of the rulebook on their contract.

In our overall submission, it's a matter that's readily able to be addressed in the ordinary way by the applicant in its rulebook or in amending the rulebook after the conference and it doesn't of itself raise a competition issue for the Commission.

Clearly it raises a rulebook issue in the sense of would the rulebook need to be amended? It raises a rulebook issue in the sense of the point that David made earlier today, which is that if Meridian doesn't come aboard, or if Transpower doesn't come aboard then we don't have a rulebook in operation.

CHAIR: That point was made very clearly, I accept that.

MR KOS: The response is detailed quite briefly, it won't take long, in relation to this at 16.7 on page 62, and we start by making the point that - the first point which we make in points A to C is that we don't think actually there'll be any point of difference here between the models, in other words between the counterfactual and the proposed arrangement. There would be no practical difference.

We make the point in B that under the Commission's counterfactual the Crown EGB would retain the part F rules including the vote mechanism and would have greater powers to override the outcome of the vote to force transmission investments if it considered it was in the public interest. So, they both have similar, if not identical, rules in relation to industry consideration of transmission changes.

So, we submit firstly, there's no point of differentiation. But the second major point is, it doesn't mean we're not taking the concerns expressed very seriously. It's certainly not intended, the provisions of the rulebook should undermine existing obligations under long-term contracts, and nor is it of course intended the potential operation of the rulebook should deter investment, in fact quite the contrary.

So, some clarification of the book is required to address the concerns expressed by these three submitters and that's a matter which would be addressed.

There's a question still for discussion with those three submissions as to whether an amendment is required. That's a matter of discussion and negotiation which has to occur but if the conclusion at the end of the day is that it is, or should be pragmatically done, then that's something that will have to be done.

After the conference is done, our submission is it doesn't raise a competition issue.

MS REBSTOCK: It may raise a competition issue, there is the question of whether that's any different than the counterfactual, but you say that it's a matter that can be readily addressed by the applicant in E. What do you mean by readily addressed? Do we have a means by which to fix this issue?

MR KOS: Yes, because the rulebook is going to go through this process of a number of amendments. It's not intended that an existing long-term contract should be overridden. This - certainly of this nature should be overridden by the rulebook and so if effectively a caveat for this contract has to be provided for it, I'm sure it's not overridden, that's the a matter that the applicant would address with those parties.

MS BATES: So, just let me try and clarify, legally the rulebook can't affect the contractual terms as between the parties, or it shouldn't be able to

MR KOS: The rulebook is one contract, and so the submitters say inconsistent contract

MS BATES: There's a pre-existing contract but it puts somebody who joins the who joins up in the position where they can't possibly comply - they may not be able to comply with both contracts.

MR KOS: That's the issue and the avoidance of that conflict is the object. Now there may not be a conflict as I say. But that's a matter which is going to take some discussion.

MR CURTIN: You mentioned in your point F, on page 62, that there's a group working to identify the Comalco concerns more clearly and there seems to be an element of where's the beef here. It isn't entirely clear what the issues are. I suppose, would you care to take an enlightened stab at what you think the issues might be?

MR KOS: That would require my, in my case understanding quite what it is Comalco is getting at in the letter that's been sent. I'm not sure I'm sufficiently enlightened by that to express that.

MR CAYGILL: Beyond the point that we've already traversed about whether it is unclear if the contracts intersect and are inconsistent, which prevails, that implication from the letter is clear enough to me, beyond that I'm not confident that I fully understand what other issues may lie here. I'm not sure whether Kieran can shed light on it. I think that is the fundamental question and in that sense it's not new, but we accept the letter indicates that the matter needs to be clarified, needs to be addressed and there's no reluctance on anybody's part to do that.

MS BATES: Mr Caygill do you think the answer is unclear as a matter of law?

MR CAYGILL: I don't know is my short answer to that. I have not researched the matter myself. It's been sufficient to me to say if there are three significant parties, all of whom are concerned about it, that's good enough for me to say let's get around a table and sort it out.

MS BATES: Do you have a view on it Mr Kos?

MR KOS: Yes, in terms that you and I would use in another place, we would look at the letter of the 22nd of May and at the fourth paragraph and immediately ask for further and better particulars.

MS BATES: Which no doubt you'd like us to do?

MR CAYGILL: We've agreed we will do it.

CHAIR: I think we'll just listen to what those three parties will have to say to us. They'll no doubt come back to the Commission or someone if that cannot be negotiated between the parties I would have thought. But they're pretty critical to your arrangement full stop.

MR CAYGILL: Which is why we have an incentive to sort it out and they have an incentive to make sure that's happened.

CHAIR: That's right. All right, taking Denese's comments in mind, we'll move on I think if that's all right.

MR KOS: The next topic is number 17, the position of conditions. We note that the draft determination noted the ability to grant an authorisation, subject to conditions, and the question of whether that might be appropriate in this case and what those conditions might relate to.

As we note at 17.4 we submitted that the Commission had a broad discretion to grant the authorisation subject to conditions. We weren't at that stage in a position to express the detail of such conditions. There was a process that had to go through the governance working group, and the EGEC, which has occurred, and as soon as that occurred and the terminology was determined we of course wrote to the Commission and those conditions have been circulated by the Commission on the 6th of June.

There are some supporting submissions and there are some opposing submissions in relation to the two conditions that have been advanced by the applicant. The opposing conditions suggest that this is effectively a new application as a result of the two conditions advanced which all parties should have a further opportunity to make submissions on and there are two letters of objection of a somewhat formal nature by Transpower and MEUG. Now we want to respond to that in three or four ways.

The first is a general point. We note that three parties have objected, despite the extent of the Commission canvassing submitters expressly and asking for comments. We note secondly, as a general matter, that the power of the Commission to impose conditions is wide, subject only to the important qualification of consistency with the Act and there is no need, we submit, for the conditions to be minor or trivial as Transpower suggests in its submissions at paragraph 110.

Then we note the practical, with respect obvious point that conditions may be fixed by the Commission as part of a final determination and need not be the subject of prior application or consultation, which is what happened in the one example that comes to hand because there, of course, have been relatively few such applications of authorisation restricted trade practice and only one of those has involved express conditions of this kind.

That was the kiwi-fruit case where the conditions were imposed by the Commission in its final determination. Indeed, when you think about it, practically they will seldom be part of the original application conditions unless they're presented as some kind of optional part. They're most likely to arise as a consequence of the draft determination or the conference, and in our submission there can be no basis to preclude the applicant in response to a draft condition raising the prospect and the detail of conditions. That's the most efficient way to proceed.

The Commission has exercised its discretion to grant an authorisation in the kiwi-fruit case, as I mentioned, and we've also referred to the Australian Trade Practices Tribunal exercising equivalent discretion in the media council case in that country. That's the first and general submission.

The second submission relates to where they might be imposed and the best guidance on that in our respectful view is the Commission's decision in the kiwi-fruit case, which stated that conditions designed to enhance competition or to remove detriments flowing from the absence of competition could be appropriate and that's exactly what's proposed in the present case. The rule change proposed in relation to voting arrangements is designed to remove a perceived detriment and the extension of the exemption regime is designed to facilitate parties engaging in alternative trading arrangements if that has a net efficiency benefit and thus as a competition enhancement. So, that's a second general level.

The next points really relate to the nature of the conditions and the context in which they've arisen. The first of those conditions in relation to voting arrangements in fact addresses an aspect of the application that Transpower has raised a potential problem about. The prospect of anti-competitive voting will delay on rule changes. We've referred the Commission in this paragraph to a number of paragraphs from Transpower's submission. But paragraph 63 in particular is illuminating, where it talks about a plain need for an independent and accountable decision-maker.

That, in our submission, would be what you would clearly get in relation to this question about potential anti-competitive or pro-competitive rule changes not being voted down with the second vote, or the second vote and Rulings Panel appeal if the Commission felt that was necessary to ensure that the application crossed the threshold of net benefit.

MS REBSTOCK: Can I just ask you a question there. I mean I noticed in the letter that you sent us with the conditions that you constantly make the point that we could consider these conditions if they were necessary to be satisfied that the benefits outweigh the detriment. Is it your view that that's the only circumstance under which the Commission can impose a condition? In order to change the - I mean in some of the cases that you

quote, I don't think it was the case that it was necessary in order to change the answer from a no to a yes. But it was a condition that was applied because for whatever purpose, without going into it, the Commission thought it was important for competition reasons to do so. So, when the applicant in stating its position, is it simply stating its position that that's when it thinks the condition should be applied. So are you stating a legal view that that is the only circumstance that the Commission can apply conditions?

MR KOS: I'm not sure I would be quite as absolute as the last point. But in essence, that is the position we put forward because we're back into this discussion we got into yesterday about what the function of the Commission is in relation to this application and in our submission the application is, the application - and that it's no part of the Commission's job to improve it. Now, I'm sure that's not the Commission - the Commission knows that, doesn't need that instruction, but there is a sense in many of the submissions that you have received that there are tweaks that people would like. That's - to tweak something not what this process is about.

The application is before the Commission and the applicant has said we want that application to be judged. However, we've also said that if the application is judged in arrears on the benefit detriment test, then we would be content, but only then, with those conditions being imposed.

MS REBSTOCK: I understand that's your preferred view. But I'm asking you what is your interpretation of the statute? Can we impose conditions - I understand the issue about the role and everything but just can we impose conditions when there isn't an issue there about the net detriments, about there being net detriments? I mean you indicate we have wide discretion with respect to the provisions of the Act, and when I read your piece that you gave us today, or yesterday, I don't see you saying that, but in your letter and in your presentation just now, you narrow that discretion down. I don't know if it's because of your interpretation of the statute's limitations or it's your preferred approached that you're recommending to us?

MR KOS: In the interests of intellectual honesty, which probably ought to have a place, I'd have to accept that as a matter of interpretation, as a matter of precedent, the Commission has the power to impose whatever conditions it wants to. It's then a question of course as to whether the resulted, distorted child that's produced, is in fact adopted by the applicant because the question becomes then whether what has been authorised is something which the applicant is prepared to proceed with.

CHAIR: It cuts both ways. As you say submissions made to us by two parties anyway make the point that this could be in their view a substantial change, in fact warranting a new application. You've just said a minute ago that you don't think tweaking it in relation to these two suggested amendments or conditions is necessarily inconsistent with the current application.

MR KOS: No, because the nature of the changes in our submission is minor. But it's --

CHAIR: Yeah and secondly the point you're making in the paper that you're speaking to, you say that people in fact were aware of these possibilities quite some time back.

MR KOS: Thank you Mr Chairman. That's the point I wanted to come on to, that the conditions in our submission are minor and they're iterative in nature from the rulebook that's before the Commission. In the context of that book as a whole, and in our submission, they don't give rise to any need for new application, nor is there a process issue. That's an application issue, the jurisdiction issue, it's a process matter. There's - they've been proposed in response to specific queries, specific concerns raised by the Commission, were notified as soon as they could have been but in relation to the two parties that have expressed formal

objection, they were consulted on these conditions far earlier than the 6th of June and David can comment on this in a moment, but we've set out the chronology at the bottom of page 64, and you will see from that that it's the nature of the conditions.

The drafting of the conditions was in front of Transpower and then MEUG as early - in both cases, 24 May and 10th of May in the case of one of them. So, in our submission it would be disingenuous to suggest the proposed conditions have just come to their intention if indeed that is what they suggest.

It's also in our submission just a little serious on the part of one of the submitters, Transpower, to raise this objection, because in its own submission it's suggested that the entire rulebook as opposed to the specific provisions that we have advanced could be authorised and so I'd suggest there's a measure of inconsistency and opportunism in the argument being put forward.

MS REBSTOCK: Can I just come back to the question I just put to you. I'm going to do so because I want to give you the chance to comment on it, either now or later. It seems possible to me to interpret the statute to say that we do have discretion to apply those conditions and they don't have to necessarily be in a situation where it changes the answer from a no to a yes, possibly.

If we came to that view, I just want to put to you that it could be that provision like that allows us to deal with a situation where - that might otherwise arise, where, and I'm not saying that you've done this, a situation where we get a bundle of proposals put to us for authorisation, there is a lot of benefit from some aspect of it. But bundled within it are some proposals that are clearly anti-competitive and are not at all necessary to achieve the benefits that are put to us. Because you put enough benefits in you get - authorise the bit that gives us serious concern.

So conditions give us the ability to deal with that. So, there may be a reason, leaving aside the issue of role and all of that, in which you can understand why conditions like this - the ability to impose conditions exists. So, I think it's important because the Commission hasn't had to deal with this in such an environment as this before to get your comments on that.

MR KOS: I can answer it in two ways. I've given you the first half of the answer already. Which is that you can impose what conditions you end up deciding you should impose. Then as I say, the question is whether - the applicant says well, this is something that's so far removed from what I want that I'm not going to go any further forward with it.

The second half of the question is for what purpose you can impose those conditions. I would not want to subscribe to the idea that you had a free hand in modifying the proposal to remove some anti-competitive parts of it, because in a sense that is why we are here. We are here with a proposal which is itself a curate's egg, has some good parts and some bad parts.

We say that's our proposal, we say the sum of the whole is beneficial and we want you to approve it. According to section 61.6 that's how it goes. The Commission's not to authorise it unless we can get you to believe that the whole ends up with a positive outcome.

The second part of that answer though is to say the provision in which the Commission can impose conditions is in the same section as the section which deals with the basis on which the Commission exercises its authoritative power. I don't think you can divorce the two at all. So, that certainly at this stage, and I'll come back to the question in reply when I've given it some more thought, certainly at this stage I would have thought the correct interpretation is that the imposition of conditions is for the limited purpose of ensuring that the outcome achieves a net benefit. It doesn't in my submission enable the

Commission to say, we can pick out some bits which are anti-competitive and make this an even more competitive proposal.

MS REBSTOCK: No, that's not what I was trying to suggest. I appreciate the focusing in on that. Can I just ask --

MR PALMER: Could I add another part to that answer? I think this is the third half. The third part to the answer is that a broad interpretation of the condition section is not required to deal with Trojan horses. If there's genuinely an arrangement which has a nice feature which is used to, just to allow a nasty arrangement to come through, merely because there is a net benefit doesn't require the Commission to authorise it, rather section 61.6 says the Commission shall not authorise a determination unless a reason for not authorising, despite the existence for net benefit I would submit would be the Trojan horse.

MR CURTIN: Just very briefly and again I'm not suggesting at all this is how things might pan out, but when our Australian regulatory cousins were looking at the Australian National Electricity Code, the outcome was pages and pages of stuff, conditions, drop this, change that, delete the other. As I say, I'm just wondering whether you had observed the Australian approach and had any comments on it, without in any way indicating that's a likelihood on this side of the water?

MR KOS: I don't think any of us have, it might perhaps be useful if we did look at that, if we may come back, if there's something useful in there. Is there a particular aspect you'd like us to focus on?

MR CURTIN: No, it was more the general approach they followed and the reasoning. I suppose you'd characterise it as a reasonably activist approach to the use of conditions, very limited experience over here doing anything on that scale. If you have no opinions either way on whether that was advisable, how it stood legally, any feedback you've got on how the Aussies handled a comparable situation?

MR CAYGILL: I think that would be useful, because I surmise the answer lies in a different regulatory approach more generally, but I'd rather be confident of that.

CHAIR: You're probably right on the last point. Nevertheless it might be worth looking at. It is very prescriptive.

MR KOS: One would suspect a raft of conditions probably wouldn't have emerged without considerable discussion.

MS BATES: It's feasible, there's a similar power to impose conditions in the Australian legislation.

MR KOS: There is a very similar provision, but I'm not sure whether the particular decisions was made under that provision or what the procedure was leading up to it.

MS BATES: It may be that there's case law on the interpretation of the section itself which would be helpful, that's all.

MR KOS: And particularly the Media Council case that I referred to in the submissions here.

MS BATES: So that's the only one that you've been able to find, is that right?

MR KOS: That was the only one that was at all illuminative, it may be the only one at all.

CHAIR: I just make the point, you're probably aware, apart from the case you mentioned there are very few occasions where we've imposed them anyway, certainly in the other parts of the Act in relation to mergers and clearances, we have been very circumspect.

MR KOS: You did get a tick from the Court of Appeal in relation to the exercise of the power.

CHAIR: If it's the case your thinking about that may not be finished yet, that's another issue. We've been fairly circumspect about it.

MS BATES: I'm sorry I clearly missed your media case, whereabouts in your submissions is it?

MR KOS: Page 64, paragraph E.

MS REBSTOCK: I'd like to just put one more matter to you. If I read your

paragraph 17.7 I would say, and again I'm not saying we might do this, but this is our chance to ask you questions. So, we may have to cover all possibilities. There's a possibility that the Commission will receive suggestions from parties on what conditions might be applied and we may at the end of that come to a view that yes conditions should be applied but they should be something different to that which has been suggested by the parties. If I read A, B, C, D or E here, we haven't got D, maybe it's the one you're going to add after I say this.

MR KOS: That was the Trojan clause.

MS REBSTOCK: It seems to me in the course of normal practice, while I read this and I think yes we could do that and we could make it part of the authorisation according to you and not necessarily come back and consult with you on that, it would not be the Commission's normal practice to do that for very good reasons and so I want to ask you if, and this is a big if, there's no intention at this stage to do so, but if we were to think conditions were appropriate and they were something different from what had been discussed at this conference, would you still - would you not think it appropriate that we come back to you and consult further on that.

MR KOS: I think if the Commission felt that as a matter of process that was desirable on a broad view, not necessarily just a legal view but a broad view, that would be an appropriate course. I would imagine that the conditions, well, conditions might or might not be ones that have been submitted by parties. We haven't yet commented on Meridian's condition because in the preparation for this I'm afraid we just simply didn't give due attention to that, and would like to.

We will comment on that in the reply, if the Commission felt it wanted to in relation to that matter alone, certainly we wouldn't have a problem with the idea of being questioned at that time on that, as we haven't had a chance, well we haven't taken the chance to comment on it at this stage.

MS REBSTOCK: I guess that the aspect of this, and I come back to the conditions that the applicant has framed with the provisos that you've put around it, and generally the Commission would normally have the practice of not only giving people an opportunity to see conditions you presented, but to ask for comment in light of a draft view from the Commission on them.

In other words, they'd have an opportunity not just to comment on them as presented by the applicant, but in light of a view express by the Commission, should it decide to adopt those conditions. So, in that sense, I just want to put on the record that the Commission normally would have some sympathy with the need for processes to be followed to give people the chance to comment, not just a view put forward by an applicant, but also a draft view of the Commission itself.

MR KOS: I think two answers. First, at the end of the day it is a matter for the Commission to assess how its own processes should run on that particular matter. I do note in the case of the kiwi-fruit authorisation it doesn't seem to have been the approach taken there. I don't know why that was.

The second answer is, I guess that is an argument because you can imagine the process becoming potentially, slightly endless then. I guess that's a reason to encourage the Commission to look at conditions that have been advanced by submitters where there is the conference which provides the opportunity for consultation, even if that is shorter consultation than on the original application which by definition it must be.

MR CAYGILL: Can I add one codasol to that without disagreeing with any of it. However I think the applicant would far prefer the Commission to conclude that that was a process which was available to it and which it ought to follow than we would have you conclude that such a process was not available to you and on that account the application needed to be

declined however were we to re-apply on a given basis, perhaps the outcome might be different. As between those courses, I think the applicant has a clear preference which wouldn't surprise you.

CHAIR: We'll note that certainly. But others may have a view on that particular point as well.

MR CAYGILL: Yes, but with respect if their view goes - if their view goes not so much to preference as to capacity, then we say the capacity issue must surely be answered by a plain reading of section 61 and the precedent of the kiwi-fruit case.

CHAIR: Understood. Thank you for that. I think that has explained quite a number of issues.

MR CAYGILL: May I just clarify one brief factual matter. It has to do with timing. I believe that all the parties, all three who have objected to the imposition of the conditions suggested by the applicant in response to the draft determination were aware of the language that we were considering from the 10th of May. I don't want to over-stress that because that's still not a long time, but whereas the Commission issued its draft determination on 26 April and specifically invited parties to consider whether there were suitable conditions that might be addressed in relation to certain issues; we circulated our proposals internally, not to all the world, on the 10th of May. But in as much as MEUG , part of CC 93, and CC 93 have had two representatives on the Establishment Committee, I believe that Transpower, CC 93 and MEUG would all have had those proposals able to be considered.

CHAIR: We'll obviously take notice of what you've said and may of course wish to raise them with them but you're on the record here quite squarely. I would just make the point the last comment is your comment, the bottom of 65, that's yours.

MR CAYGILL: Indeed.

CHAIR: The benefit and detriment analysis which I think is put down at Keiran Murray and Eric Hansen I think.

MR HANSEN: May I refer the Commission to table on page 69, the intention is really to follow down that table line item by line item. Much of the detail of the applicants reassessment is presented in the applicant's submission and also in the paper Kieran and I submitted - reported on this year.

Broadly speaking we've adopted the Commission's structure, not only in terms of the table but wherever possible the method of calculation which was some variation on the way we did it and so what we really aimed to do was just highlight some differences.

The first item, lower cost of capital. We've noted earlier that cost of capital estimates can be developed and used for two different purposes. We reject the New Zealand Institute of Economic Research assessment that it's a double counting. We certainly believe, assert, that the approach adopted by the Commission is appropriate.

The difference in our assessment is, as indicated earlier, is rather than including only privately owned generation retail entities we have included also the State Owned Enterprises. That therefore increases the asset base to which the cost of capital is applied and results in a $26m net present value higher benefit, and our assessment relative to the draft determination that's in mid-point terms.

MR STRONG: There would be some potential for double counting. Does the Commission need to be quite explicit in how it sort of treats the increase in cost of capital and whether that perhaps could subsume some of those, as you've termed it, certainty equivalent assessments of benefits and detriments?

MR HANSEN: We may need to - I mean I think to really get right to the bottom of that one we'd have to work out a full analytical model. It is clear though that to the extent that the efficiency estimates are based on certainty equivalent, that the actual presence of risk as a result of one

proposal versus a counterfactual, to the extent that that does actually affect participants' actions, then that is an additional benefit or cost as the case maybe. But the precise way of calculating I think would need to be, one would need to do a lot more analytical work.

18.2 industry decision making advantage, we basically adopt the Commission's approach here in estimating the net benefits, with the exception of calculating dynamic efficiency based not on production costs but on market value. It is significant in this circumstance where the supply curve is steep and has steps in it, the market value of additional output at the margin can be quite different from the marginal production cost, and so on that basis our assessment using the market value of output not production costs, amounts to 25 million net present value higher than in the Commission's assessment in the draft determination.

The second part of our assessment there relates to a claim made by the institute of economic research in section 8 of their report that the scope of this rulebook really only applies to common goods and services and the network security and that that only itself applies to about 10 percent of the operation of the relevant parts of the industry. We would suggest that that is not correct. I think as evidenced by the discussion in the last two days those rules do potentially affect the whole operation and on that basis believe the Commission's approach is appropriate.

Moving on then to 18.3, lower transaction compliance and lobby costs, essentially no difference from the Commission. So, we've adopted the same numbers. 18.4, avoidance of over-investment in transmission. In the draft determination it appeared to us, although we weren't absolute certain about this, but it did appear to us that the section in the draft determination on over-investment also bundled in with it any issues of competition in the transmission market, particularly as we assess it weaker competition, and as you'll be aware we've treated that as a separate item in our earlier discussion and also as line items in the table at the end.

After stripping out the competition effects we effectively adopt the Commission's assessment in terms of over-investment. We do that on the basis really of three points I guess. One is Contact Energy's evidence on over-investment and generation, we do believe that has relevance. The World Bank study that we referred to in our own report; and thirdly quite importantly also, Transpower's own submission in 1999 to the Commerce Select Committee that there would be over-investment in this type of counterfactual situation.

18.5, competition and transmission services. As indicated this is a new line item that was not treated separately by the Commission. In the report that Kieran and I wrote last year, December 2001, we assumed that the proposed arrangement would result in production efficiency gains relevant to the counterfactual averaging 8 percent over ten years. This was based on a 1 percent gain in the first year increasing to up to 10 percent gain by year 5, but discounted over a period of ten years so the average worked out to 8 percent.

It's based on the view that the proposed arrangement will allow greater competitive pressure on particularly Transpower and that this then would result in greater operational efficiency gains. Our key arguments in favour of that approach relate to really the view that the Crown EGB and regulatory force that's implied by the counterfactual approach would tend to crowd out private investors. Particularly that regulation would give Transpower secure returns for its investments whereas private investors would bear the risk of developing and marketing alternative solutions. It's a rather different position.

Secondly, that potential private investors may also have to pay for the Transpower services they would like to replace as they are likely to be existing customers such as lines companies and generators in providing

subsequent services, and thirdly a Crown EGB, we have submitted, would likely err in favour of accepting the view of Transpower on the necessity for its own proposal and that Transpower would also favour its own solutions over solutions by alternative providers on the basis that that gives them greater assurance on security matters.

Also in trying to come to numbers in this area, I think we've tried to be very clear that strong and directly relevant evidence is very difficult to come by. Nevertheless, we've believed and submit that it is worthwhile trying to have a quantitative framework and to try and put some numbers up. I draw the Commission's attention to the first paper Keiran and I wrote in 2001, paragraphs 194 and 228 where we highlight the uncertainties around these issues.

Nevertheless, what we've endeavored to base the numbers on is broadly the 1980's experience with deregulation in New Zealand which saw in a number of industries and a number of particular companies quite substantial efficiency gains often in the order of 20 to 30 percent and sometimes more.

In that regard we have identified a report by the Institute of Study for Competition and Regulation which reports productivity growth following deregulation and also including the period of the formation of SOE's as ranging between 30 to 60 percent in five or seven cases that were studied in a particular paper.

This in our mind indicates scope for gains that it certainly doesn't necessarily say the gains are available in this particular case and we would particularly note that that study includes both deregulation and the shift of an entity from perhaps a state trading department to an SOE and of course Transpower already is an SOE, so we would expect some of those gains have already been realised. But our assessment, or our judgment is that there are further gains available, and really the numbers that we provided for, the 8 percent average, we believe allow for some gains to be made under the counterfactual.

In our submission on the draft determination we reduced that gain from 8 percent to - essentially we've adopted a framework that's consistent with the Commission. In our original submission we had a probability based analysis. The Commission in that case moved away from it to look at certainty equivalent approaches so dropped out the probability analysis. So, to reflect that and adopt the same approach we reduced the scope of our numbers. But essentially we believe they're equivalent.

Competition in service provision, 18.6. We adopted the Commission's assessment in respect of competition and services, so no change in that area. 18.7, strike down risks from transmission and system operator. This is the second new line item that does not appear in the draft determination. That's a new area that we introduced as part of the submissions.

We have submitted that pro-competitive rule changes are at significant risk as a result of incentives based by the transmission provider and the system operator and that this is quite apart from any risk there may be from virtually integrated generators. We have also argued that this risk is particularly exacerbated under the counterfactual as opposed to the proposed arrangement. We believe the potential impacts are quite substantial as the - take the transmission provider and system operator together, their interests and their operating activities span a substantial portion of the electricity industry, namely all connected equipment, transmission services in the whole of the trading arrangements. So we believe this is a significant area of risk that warrants attention by the Commission, we've put up several areas of evidence in support of that.

The first one in particular is annex one in the submission by Kieran and myself - in the report rather, the 2002 paper, and in that

submission we really look at two sorts of evidence. One is the sorts of statements made by Transpower that support our claim about their incentives. In this regard we're not saying their incentives are inappropriate, they're following the incentives that they would have as a system operator.

But what those statements do suggest is that the incentive to favour security issues and uniform and mandatory rules over and above pro-competitive rule changes which typically are about diversity and allowing greater diversity and greater differentiation, relaxing constraints on people is consistent with statements made and actions by Transpower and in that annex one we particularly look at the cases of Transpower actions regarding the combined cycle generation, frequency standards, and demand side participation.

Just to finish off in that area, the second relevant piece of evidence is provided in annex 2 which relates to the NZEM study and the point that we particularly make there is that when you look at the ten areas where rule changes have been delayed or taken some time to go through, we actually found that in six of those ten areas, Transpower had pretty significant issues and concerns. That again I think supports our assessment that this is a significant risk.

So to make an estimate in this area, what we've done is really adopt the same framework the Commission adopted in terms of pro-competitive rule changes for generator retailers, but on the basis that it applies under the counterfactual rather than the proposed arrangement. That came to a net benefit in the range of 50 to 100 and $5m. Incorporated in that is the efficiency measure, the market value in the dynamic efficiency.

One thing to point out there in terms of assessing whether that's a realistic number or not, is go back to the discussion I think we had immediately after lunch when David Caygill was referring to the under frequency standard. Just to note in that one particular instance the estimated range was 3 to 20 million. So potentially a significant number, even relative to the number of work we've got there in its entirety. So, we believe we've actually been quite conservative in that area.

CHAIR: Thank you very much. We'll certainly have a look at that 18.7 obviously from the points you make there. Just one point, in your comparison with Lew Evans' estimates in relation to efficiencies both through changes in regulatory structure as well as privatisation, are you assuming that because of Transpower with its natural monopoly position may not have had the same efficiency gains as other SOE's subjected to more market competition?

MR HANSEN: That's correct, the study we refer to are looking at SOE's that are operating in competitive markets.

CHAIR: So it follows that not being a competitive markets, there may still be some gains there.

MR HANSEN: That's point we're making and we're really trying to indicate the potential scope but not really say much more than that.

MR MURRAY: Part of that, Mr Chairman, was the conversation earlier today around what the intention of part F was to create a mechanism where contracts would be agreed or transmission or by substitutes for transmission which didn't previously exist.

CHAIR: Putting more pressure then on the transmission system.

MR CURTIN: Just if I could just understand that new item of the strike down list from transmission and system operator. The counterfactual I presume that you've been working with is that basically Transpower is a law unto itself, whereas in the industry EGB its ability to have a dead hand on innovative experiments or what have you is - are you saying it's completely limited in the industry EBG, it would still have some influence perhaps in reducing the degree of innovation that might

otherwise occur? I'm just trying to get a feel for the counterfactual Transpower is completely in demand and everything it says goes, and the industry EGB assessment is that nothing that Transpower says is a veto, or is there some kind of spectrum in the middle when you came to those numbers?

MR HANSEN: Certainly not the extremes. I mean what we are saying is that the industry parties - that Transpower under the proposed arrangement is one of the voters. It has to convince others that it's right. Other voters being actual market participants are at the coalface and they see and bear quite directly the cost of action or even the potential for action to use their plant more efficiently. That may not always be, we believe probably in a lot of cases, not readily apparent to a central decision authority.

Related to that, or on the counterfactual side, we're certainly not assuming that Transpower always gets its way. But what we are saying is that two points really. That the Minister and the Crown EGB are inevitably going to be somewhat removed or more removed than industry participant. They will have some difficulty second-guessing Transpower's view as to the extent of any trade-off between grid security and competition. These are very complex issues. So, they will have some difficulty because they're at an information advantage and they're not there operating on the ground.

Secondly, from an incentive point of view, that the Minister and the Crown will have some difficulty from a political incentive point of view to counter the view given to it by the so-called, you know, the expert under system security namely Transpower. It would be very difficult in some circumstances to take on the risk that something then goes wrong, even if it was actually unrelated to the particular issue, and then find and to be held to account that it did not follow the advice of its so-called experts.

So, we think that the Minister and the Crown EGB would be more likely to heed Transpower's concerns, which may or may not be genuine, may or may not reflect an appropriate trade off between cost and security.

CHAIR: I think you mentioned that concept earlier today as one of the fundamental issues surrounding the application anyway. In your remarks this morning you made that same point I think.

MR CURTIN: I think just to assist the staff, I know in your first calculation of the quantification there were quite detailed tables of calculation per item at the back. In this latest one I suppose what I'm saying is I'm finding it a little hard to source for myself and have a look at your 50m to 105m calculation. Perhaps it's there or there's some way of reconciling it to the breakdown by allocative productive dynamic efficiencies. If you could either point me or the staff in the right direction as to that number for the strike down risk from the system operator and how it was built up I'd appreciate it.

MR HANSEN: More than happy to forward on the spreadsheets in that area. But what we actually did in that area was to adopt the calculations - what we did is set up the same spreadsheet as what the Commission had for strike down risks for generators and virtually integrated generator retailers, verified the numbers there, we added in our new estimate for dynamic efficiency based on market value as opposed to production costs. We then made the assessment that this risk also applies from a transmission point of view from this point of view but actually applies as a --

MR CURTIN: As a minus, as an opposite.

MR HANSEN: So effectively we didn't create a new table we made the assessment that that table could be used for this purpose with a new number, so it doesn't appear. The calculations are no different. I can just check back to make sure that's true. I'm pretty confident that's what we did.

CHAIR: Just before you move on.
MS BATES: This is probably the last opportunity I've got to ask a question of you because I don't think we do it in reply, do we? So, forgive me if it's at a high level. But assuming that we consider that the objectives of the legislation, and I mean the Electricity Amendment Act, is a public benefit, assuming that we come to that view, which model is more likely to achieve the objectives of the Act? And I don't want a litany of reasons why, but overriding reasons why.
MR KOS: Well I'll offer a very short, not a litany but one line. That is an assessment which we can assume I think that Government, Parliament, which are highly sophisticated bodies, can make as to where benefit lies and the net benefit assessment that those two bodies have made clearly is in favour of the self-regulatory model. That's the one line answer.
MS BATES: So you say because Government says that's - that will be the best model.
MR KOS: That must be a very influential assessment of perceived benefit, particularly when one sees the degree of common view across the Parliamentary parties.
MR CAYGILL: I'd like to say something about the assessment made by Parliament in addition to that. The Government's expressed its assessment of its answer to that question I believe in its policy statement which expressly indicates its preference, if not its rationale. Parliament adopted the legislation which the Government presented to it, but I - which includes both possibilities. But I believe Parliament accepted and I believe the Parliamentary record discloses this, that the Crown EGB was there as a fall-back. Otherwise there was no point to the subpart dealing with Electricity Governance organisations. So, Parliament wasn't merely accepting the Government's preference, it was accepting the purpose behind providing those powers.

Now there were some members of Parliament who made it clear that they were reluctant to see those powers ever exercise. That's fine, there was not an identity of view right across the range of opinion represented in Parliament. But Parliament saw a particular purpose behind providing that power to a future Government and in that line I concur with Stephen. I believe Parliament adopted the same preference of the Government when it embraced legislation that provides the two alternatives.

CHAIR: You made the same point yesterday when you started off tracking the history in terms obviously we're well aware of your position on that.
MS BATES: Thank you.
CHAIR: Anything else Nathan before we move on to detriments?
MR STRONG: I wonder if we could go back to the strike down risk from the transmission and system operator. Your submission, if I have it right, is that the Crown EGB is likely to be captured by system operator and Transpower and therefore there is this risk of crowding out. Under the industry EGB votes are allocated to transmission operator, system operator, and generators retailers etc. Just wonder if you could articulate how - and presumably those parties will have different information sets about competitive substitutes for transmission while Transpower system operator will have more information about the options available to it. How would that be reconciled and how might that affect the calculation of benefits and detriments? And does your analysis take account of that?
MR HANSEN: Just first of all a slight clarification there. Transpower as transmission provider would receive votes but as system operator is a contracted service provider and doesn't have votes. If I understood your question correctly it was how do the various information that's embodied in different participants get reconciled. That in reality comes down to the setting of the majority required I believe. A 50 percent majority will allow the situation where there can still be significant difference

of view and whereas a 75 percent majority would require a much more uniformity of view. So, in areas where that's important because of greater coercion then you see the 75 percent. Kieran I imagine will have a follow-up on that.

MR MURRAY: Nathan, whether I understood that question correctly, we've made a suggestion that Transpower's influence would be increased in two areas under the Crown EGB. In the rule change process because of the trade-off often between pro-competitive rules and system security concerns, and secondly in transmission investments. This strike down from transmission, in transmission system operator, is in that former part, not on the transmission investment.

So, it's a rule change such as the real time market, for example talked about earlier, or the under frequency standard where the views of the transmission operator and its concern for stability and uniformity would have a greater sway under the Crown EGB than under the industry arrangement. So, there isn't there the explicit trade-off necessarily between a transmission investment and the rule change.

MS BATES: I just wanted to follow-up the line of questioning I had engaged in with you. I understand the concept that Government has preferred, said its preferred an independent EGB, but just observe that it wouldn't say that any independent EGB was necessarily going to be better than a Crown EGB. So really the devil is in the detail, it's whether they're proposing itself is going to be more effective.

MR CAYGILL: Absolutely, and that's precisely why the Government wanted to have the fallback enacted so that the stick is available to be uplifted if need be. But with respect, I don't think the industry has ever had any problem with the notion that the Government would make that judgment. We said explicitly to ourselves as an establishment committee, the design criteria had been set out clearly in the Government policy statement, we do our best in relation to that. Ultimately the Government must conclude, as the industry needs to decide whether it supports this in principle, then individually they need to decide whether they will join, then certain certificates need to be rendered and so on, and finally the Government gets to stand back and look at all of that and say well that's fine but are we satisfied? And precisely in order to avoid getting to the cliff face where we thought we'd done it all right but it turns out we didn't. We thought it prudent to have discussions from time-to-time. I couldn't say that that commits the Minister, clearly it doesn't. But in the process of reporting every two months to the Minister I think I can say as the chairman of the Establishment Committee, we have a reasonable degree of satisfaction that we are not wasting our time.

MS BATES: I'm glad to hear that Mr Caygill.

CHAIR: I can assure you we'll take very much on board what you're saying. I just make that point.

MR CAYGILL: It is for the Minister to make the final judgment but we've tried to explore that we're heading in a broadly acceptable direction.

MR KOS: One of the reasons why you are is because the rulebook presented is not some new strange apparition dreamed up over a feverish night.

MS BATES: We didn't think it was Mr Kos actually. A strange night indeed if that's how you spent it.

CHAIR: I just assure you we're well aware of this.

MR KOS: It's based closely on the three codes that the GPS anticipates with the additional transmission services, so it's not a stranger to Government.

CHAIR: I want to reinforce we certainly hear what you're saying. I wouldn't want you to think otherwise. Having said that because we're having this hearing we're going through it in a fair amount of detail. Detriments, Eric or Kieran.

MR HANSEN: I'll follow-up on that. Just by way of preface introduction on the detriments regarding Commissioner Bates' question from an economics point

of view, our starting assumption would be that industry parties would have superior information, superior incentives and greater capability to undertake decisions and then the issue becomes, we traversed this yesterday, what are the circumstances in which that wouldn't work.

The two are maybe where monopoly power may be exercised and two where there could be externalities. It turns out that's exactly the two issues that are in section 19 here. The first one relates to the potential exercise of decision rights to protect the monopoly power. So, let's discuss that one. So, while clearly we cannot rule out the risk that generators or any other party may wish to strike down pro-competitive rule changes we submit that the risk is minimal and reasons for that.

In addition to presenting comprehensive quantitative evidence and qualitative evidence from NZEM over six years, which we submit shows no evidence in support of the Commission's view, the independent board and other improvements in the rulebook plus the annual scrutiny by two officers of Parliament and enhanced regulatory threat under the EAA, we believe ensures the risk is minimal.

We also would argue that we have presented contrary evidence to each of the claimed examples put forward by other submitters. So, therefore we form the opinion that the risk truly is minimal and assess a net detriment of zero to that risk. It can't be ruled out entirely but there is on our view no evidence to support the contention.

However, we've provided an annex in our report, 3, if the Commission does not accept this evidence, what then would happen? And we worked through what we call the wait and see scenario where suppose participants did strike down some pro-competitive rules over time and work through how that would perhaps lead to a response by the Government and look at the situation where because we cannot be sure how a future Minister would behave; some maybe very strong on competition issues, some may be weak and have other issues that are higher priority.

So we look at that in the annex and come to the view working through the numbers that at worse, lessening competitive pressures relative to the counterfactual would be short-lived and correspondingly the detriment would be much lower than that which was in the draft determination.

Moving on then to 19.2, under-investment which is really about the potential for the externality for the free riding and hold up. Again in this area we submit a zero detriment on the basis of the arguments earlier that under the proposed arrangement where there is a net benefit then by definition there are a group of parties that would benefit, otherwise there could not be a net benefit.

So, a coalition is possible and the issue is really what is the likelihood of that being formed and what we submit is that this part F arrangement has been designed specifically to facilitate the forming of those coalitions and that in particular references to existing or recent under-investment is not relevant evidence to the assessment of part F in the proposal.

Just lastly on this in terms of the counterfactual, we also submit that the counterfactual involves, is likely to involve, a degree of regulatory force leading to over-investment and that this in turn can lead to crowding out of other players in the market who might have competed with Transpower. To the extent it does lead to that crowding out, that then in itself would be under-investment, not by Transpower but by Transpower's competitors or subsequent products. So we believe there's actually some potential for under-investment in that area, but assess overall a zero - those two things balance off a zero net detriment.

CHAIR: So is your underlying point that investment by others that would be more better placed for efficient investment than being crowded out by

Transpower's powers. If you're investing in distributor generation for example it takes more lines.

MR HANSEN: What we're talking about here is investment in the transmission services market, Transpower is one provider, and the monopoly provider of transmission services. Part F is designed to increase the potential for others to provide those services and to the extent that proposed arrangement does that better than the counterfactual, we would assess under-investment by the competitors for the substitute products.

CHAIR: Thank you for that. I think it's straight through pretty logically and obviously others will have a view on it. The next item is conclusion. Just before you conclude, we're obviously going to give you opportunity to respond at the end of the hearing as the applicant. But just before you sum up on what's happened so far, we had an intense debate yesterday on section 30 which I don't propose to rerun now, but you would have heard Genesis when they were making a presentation and their lawyer referred to an external legal opinion which she said she might let the Commission have if possible. If you had any legal advice on section 30 as well which was available we'd appreciate it but it would be on the basis that it would be circulated.

MR KOS: I think I can say on that that annex B looks rather like that, I can say to you that's Russell McVeigh's opinion to the EGBL.

CHAIR: That's fine. Okay well, it's over to you to conclude this part of the exercise.

MR KOS: We've had, thank you, over the last two days, Mr Chairman members of the Commission, a very thorough opportunity to debate the issues. While there are one or two matters we may want to take up in reply we don't propose to make you wait now because there's no need for it. What I will say is we're very appreciative to the Commission and the Commission staff for the thorough attention they have given and you have given to the application and also for the additional time you've made available to us so that could occur, so we're most appreciative to you.

CHAIR: On behalf of the Commission, thanks for your frankness. I also found very useful the background to all this. Having Mr Caygill I think sharing the job with yourself helped considerably on that. I just hope other people feel we give them the same hearing and I'm not sure whether a time has been set for you to reply but anyway, there'll be obviously time given to you to sum up and respond. But thanks indeed for A) the time and B) the effort. So we can conclude, and thank you to the transcripters for their patience and their fortitude. Right, the meeting's adjourned.

(Hearing adjourned at 6.03 pm until 9.00 am on 14 June 2002)