

**Mighty River Power**

1 [Hearing commences at 8.59 am]

2 **CHAIR:** All right, good morning ladies and gentlemen. 9 o'clock  
3 having arrived, I suggest we get underway.

4 The first submitters this morning are Mighty River Power,  
5 and I'd just like to welcome them to the Conference.

6 We try and be as informal as practicable, and don't allow  
7 cross-examination per se, but the Commission does look for the  
8 opportunity to ask questions both on your witness submissions and  
9 any comments you want to make and, unless there's any  
10 particularly confidential issues you wish treated that way, we'll  
11 try and run the hearings as open as we can so that all parties  
12 have the opportunity to hear what others are saying.

13 So, without further ado, perhaps introduce yourselves  
14 formally and let's get underway.

**PRESENTATION BY MIGHTY RIVER POWER**

15  
16 **MR WATERS:** Thank you very much. My name is Bruce Waters. I'm  
17 legal counsel and Corporate Affairs Manager. Beside me is David  
18 Reeve. David has the interesting title of Industry Strategy  
19 Manager. David will be the one that will be primarily talking to  
20 the submission.

21 We'll commence, if it suits the Commission, to just do, I  
22 guess, a very brief precis summary of our submission and again,  
23 if it suits you, then open for questions and/or comment.

24 So, without further ado, if I can ask David just to provide  
25 that brief precis summary.

26 **MR REEVE:** I think we'll start by saying that Mighty River Power  
27 supports the application of the EGBL application. The key things  
28 that we think the application delivers is, we believe that it  
29 ensures balanced governance in competition, and we believe that  
30 it creates the appropriate and balanced tensions between  
31 interests that are likely to be dynamic in nature and interests  
32 that are likely to be allocative in nature.

33 We believe that it will provide competition and investment,  
34 which we believe is critically important, and we believe that it  
35 provides for integrated and open decision-making in the  
36 development and operation of the whole electricity network, and  
37 from that point of view we generally believe that it provides net  
38 benefits.

39 In terms of why we generally believe that it -- sorry, I'm a  
40 little bit nervous.

41 There is always going to be quite a substantial tension  
42 between investors in the industry who will seek generally perhaps  
43 a greater degree of dynamic efficiency, and there will always be  
44 generally consumers who will seek, generally, allocative  
45 efficiency, this in a process that sufficiently balances those  
46 interests. We would expect to have robust outcomes over the  
47 long-term.

48 We think that the structure of the industry EGB proposal  
49 does balance those interests; it may not do so perfectly. We are  
50 unsure that the Crown EGB does ensure that outcome. We note that  
51 it doesn't necessarily -- that's, it may present that outcome,  
52 but that outcome is not ensured.

1           In terms of the competition concerns, we don't believe that  
2 the current governance arrangements for the proposed industry EGB  
3 arrangements encourage deliberate anti-competitive behaviour. We  
4 did note in our submission that the nature of the process, with  
5 its checks and balances, does have some element of conservatism,  
6 and that does make it difficult for new or marginal ideas where  
7 benefits are not clear to pass. We don't believe that is a  
8 failing of the process, but that is maybe an issue that needs to  
9 be borne in mind.

10           In terms of the proposal from the EGB, the extra conditions  
11 on the --

12 **CHAIR:** Those additional rules?

13 **MR REEVE:** Yeah, additional rules. Our view on those is that it  
14 does enable the question to be framed in a different way. Our  
15 suggestion is that generally, if a question is framed in a way  
16 that there's an absence of clear benefits, the status quo tends  
17 to be the default outcome. We believe that allows a process by  
18 which the question is actually framed in such a way that it's  
19 suggested that there is a benefit and, therefore, the question  
20 comes, can you actually identify clearly detriments and  
21 facilitate in the absence of clear detriments that the default  
22 could be a change? So, we believe that addition is wealth  
23 maximising.

24 **CHAIR:** Do you think on the timing of those suggested additions  
25 being circulated that the Commission should be able to consider  
26 them as part of this application?

27 **MR REEVE:** Yeah, we believe so. I can't comment on the legal  
28 process, but from a pragmatic point of view, if it expedites an  
29 efficient outcome we would certainly support that.

30 **MR WATERS:** We certainly don't support that this sort of throws back  
31 to the beginning of the process; I think that's --

32 **CHAIR:** You wouldn't take that view, no.

33 **MR REEVE:** I've already touched on the fact that we believe that the  
34 balance between dynamic and allocative efficiency is one of the  
35 critical and overall quite contentious issues overall in  
36 electricity markets worldwide, not just in New Zealand. They are  
37 very much conflicting, not just because of the natural tension  
38 between them, but because investments in the electricity industry  
39 tend to be very long-term and there's also significant investment  
40 capital involved. So, as well, as there being a natural tension  
41 from the point of view of -- that actual tension, there's also  
42 tension between short-term and long-term outcomes, and from the  
43 point of view of investors in the industry, it's in their long-  
44 term best interests to have a stable sustainable long-term energy  
45 market and, therefore, they -- it's not in their long-term best  
46 interests to be anti-competitive for short-term gains. We don't  
47 believe there has been any overt anti-competitive behaviour in  
48 past governance decisions.

49           One of the areas that Mighty River Power feels quite  
50 strongly about is the overall integrated framework of, not only  
51 the energy market but also the transport mechanism and the  
52 security arrangements.

1           We have concerns in the conflict of interest between the  
2 system operator also owning transmission assets. We believe that  
3 the industry EGB proposal would be inclined to facilitate a  
4 multi-party decision-making process, and would overall achieve  
5 better long-term outcomes than a single decision maker will make.  
6 Again, we couldn't state that the Crown EGB would necessarily not  
7 achieve that as well, but we don't believe that that outcome is  
8 ensured.

9           We also believe that there is an issue with information and  
10 resource asymmetry, the system operator does have significant  
11 access to information and resources. That makes it difficult for  
12 a regulatory body divorced from the wider industry to match the  
13 system operator in terms of information and resources. We  
14 believe that the industry EGB would have access to greater  
15 information and resource overall, and that would help balance the  
16 asymmetry.

17           So, in the interests of keeping it relatively short, in  
18 summary, we think the arrangements do provide balance; we think  
19 that it does balance the economic interests -- balance the  
20 economic interests; we believe that the long-term stability of  
21 the market is the important thing; we believe that this provides  
22 for that, and we believe that the industry EGB will provide for  
23 efficient multi-party decision-making.

24 **CHAIR:** Thanks, Mr Reeve. I'll just ask the Commission now to ask  
25 any questions or comments.

26 **MR CURTIN:** You had some interesting comments to make on pages 6 and  
27 7 of the written submission, and these are largely about  
28 inefficiencies in the transmission network, loss and constraint  
29 surpluses and how they've been rising over time. I mean, your  
30 view could have been fixed some time ago at low cost.

31           Now, that's your position, I must admit none of us are  
32 engineers, and what loss and constraints surpluses, and how big  
33 or small they should be in a modern network, I think we'd  
34 appreciate some advice on what's going on in this issue from your  
35 perspective, what the practicalities are and what you think the  
36 solution is?

37 **MR REEVE:** I think it's fair to say that integrating capacity  
38 decisions in transmission networks and energy markets is actually  
39 a worldwide problem that nobody's really cracked. So, this is an  
40 inherently complicated and difficult issue, and there's always  
41 likely to be different opinions on what is the optimal outcome.

42           I guess the key thing from out point of view, without  
43 wanting to focus too much on the detail, is that it's likely that  
44 the best overall decision on how to balance competing interests  
45 and integrate the whole electricity network, is likely to be if  
46 decisions are made in an efficient multi-party manner rather than  
47 being dominated by a single party, which we submit is the status  
48 quo and may be a risk under the Crown EGB.

49           Does that answer the question?

50 **MR CURTIN:** I think so. I think your point -- I understand your  
51 point about the EGB might lead to a meeting of minds on some of  
52 these issues.

1 I suppose I was also trying to get from you, maybe, some of  
2 those practicalities we were talking about so we could get a feel  
3 for what some of the real issues are.

4 **MR REEVE:** I can use an example. I'm not sure in this context it  
5 might be the perfect example, but I mean -- during the potential  
6 energy shortage in the winter of last year there was a problem  
7 getting all the thermal capacity that was available out of  
8 Taranaki into the core network and available for southward  
9 transfer. One of the reasons for that is because a small 110  
10 KV line was in parallel with the large capacity 220 KV lines and  
11 the limitation on export was brought about by that 110 KV line.

12 The reason that that 110 KV line was left in parallel is  
13 because consumers on that line, if there was a trip, could be  
14 supplied from either direction and, therefore, to break that line  
15 at any point would have reduced their local security, but the  
16 costs, potential costs, we believe, of not allowing that extra  
17 capacity through the big 220 KV circuits was quite substantial to  
18 the economy overall.

19 Now in the end the processes of last winter did end up  
20 opening that circuit so that the extra capacity could get in. We  
21 believe that in an efficient multi-party decision process, under  
22 an industry EGB arrangement, that decision would have been made  
23 much earlier.

24 **MR CURTIN:** Thank you for that.

25 If I could just ask one other thing, and you made a point, I  
26 think, about institutional inertia in decision-making as opposed  
27 to anti-competitive buyers, and there have been some suggested  
28 amendments made to the Rulebook, and we've also asked whether  
29 people have views on whether conditions might or might not be  
30 attached to any authorisation, and I was just hoping to hear from  
31 you a little more about your kind of circuit breaker or idea for  
32 just -- a double-check idea for getting more expeditious  
33 decisions.

34 **MR REEVE:** I think -- I know it's been used a lot but it is a good  
35 example. I think the bids and offers example is a good example  
36 in this case.

37 The benefit or the net benefit for bids and offers has never  
38 been clear, and I don't know if there's one available, but I have  
39 never seen a quantified or clear net benefit case for the release  
40 of bids and offers. I should say in this case that Mighty River  
41 Power has generally believed that there probably is a net  
42 benefit, but that is an opinion.

43 In the context of the normal decision-making process there  
44 isn't a clear net benefit. The default would naturally tend to  
45 be, no change.

46 What we believe happened, and the fact that this was  
47 referred to in the Winter Review of 2001 in the Government Policy  
48 Statement, is that the NZEM effectively got asked to take on face  
49 value that there was a net benefit -- public policy declared that  
50 there was a net benefit even though that wasn't quantified --  
51 which meant the question was then in the NZEM, what are the --  
52 focus on the net detriments rather than the net benefits.

1           The NZEM got legal advice that outside of a month's  
2 timeframe there were negligible net detriments; inside a month's  
3 timeframe there were competition issues, and so, when thought  
4 about in that context the rule change proposal went through on a  
5 four week basis and the Commerce Commission application was made  
6 for the two week release.

7 **MS REBSTOCK:** I just wanted to follow up the comments that you made  
8 about the industry participants being bias more towards dynamic  
9 efficiency where there's a trade-off, and consumers being more  
10 biased towards allocative efficiency.

11           Even if we were to accept that proposition, nevertheless  
12 would you accept that we do need to be concerned about dynamic,  
13 productive and allocative efficiency and that would rather  
14 suggest that you need a balance of the different interests in  
15 order to achieve it, rather than focus on the bid that just  
16 biases towards dynamic efficiency?

17 **MR REEVE:** Yeah, we would accept that.

18 **MS REBSTOCK:** So in that sense you don't have a difficulty with the  
19 notion that the industry interests need to be balanced by the  
20 interests of consumers?

21 **MR REEVE:** We absolutely accept that the industry's interests need  
22 to be balanced with consumers. The difficulty is finding that  
23 balance.

24 **MS REBSTOCK:** The other aspect of the dynamic efficiency issue that  
25 I wanted to come back to; yesterday, and I apologise for  
26 paraphrasing but it's just not possible to find the exact quotes,  
27 I think it was strongly suggested that there's clearly been  
28 under-investment in the grid, and also that that under-investment  
29 would be fixed by the proposed Part F provisions. But it was  
30 also indicated that the reason we've had under-investment was not  
31 because of Transpower's incentives but because of incentives with  
32 respect to free-riding and hold-out.

33           You seem to be suggesting something quite different, that  
34 the industry has a strong interest in the long-term dynamic  
35 investment in the industry system and, therefore, should be able  
36 to make proper decisions.

37           It leads me to ask you, why it hasn't happened if the  
38 incentives are so strong; why have we not seen the investment  
39 that we need in the grid, or do you not accept that there's been  
40 under-investment in the grid?

41 **MR REEVE:** Yeah, we do believe there has been under-investment. I  
42 don't think we were suggesting that Transpower's incentives  
43 necessarily meant that there would be under-investment and we do  
44 believe that there is a significant problem with hold-out, and  
45 that is one of the reasons why parties struggle to agree on these  
46 investments.

47 **MS REBSTOCK:** Can you tell us a little bit about that hold-out?

48 **MR REEVE:** I'm not an economist per se, but I believe that it's an  
49 uneconomic principle that the free-riding problem often, even  
50 though parties may be absolutely better off, the chance that they  
51 might be substantially better off leads to an outcome where you  
52 don't get a resolution on a deal.

1 I'm not explicitly sure that that's what's happening in this  
2 case, but that's our belief.

3 **MS REBSTOCK:** And what is it about the Part F proposals that makes  
4 you think that those issues will be resolved?

5 **MR REEVE:** Well, I think there's two things that Part F potentially  
6 delivers from that point of view: One is that it does provide a  
7 mechanism by which, if a minority of participants that might be  
8 in a hold-out position could still meet the costs of the benefits  
9 from investment, that it would tend to mean that it was in  
10 people's interests to bargain in good faith on absolute benefits  
11 in investment.

12 **MS REBSTOCK:** How does that differ from the current situation?

13 **MR REEVE:** Well, if I could just step to the second point, because I  
14 think it might help answer the question.

15 **MS REBSTOCK:** Sure.

16 **MR REEVE:** In terms of trying to find a way through that investment  
17 problem, Transpower through no fault of its own basically has to  
18 make its own decisions on what to accept and whatnot to accept.

19 What we're suggesting is that an isolated opinion isn't  
20 going to lead to efficient outcomes as efficient outcomes is an  
21 efficient multi-party decision-making process. So the second  
22 part on Part F is that it provides a framework that means that  
23 parties do come together, and hopefully -- in hopefully what is  
24 an efficient process to make those assessments, which has the  
25 double effect of providing a better overall decision, and  
26 absolutely quantifying the benefits and where those benefits are  
27 realised.

28 **MS REBSTOCK:** Do you think a 75% threshold for a Part F provision is  
29 adequate to break up the problems around free-riding and hold-  
30 out?

31 **MR REEVE:** I'd have to honestly say I'm not sure. That is a very  
32 difficult one. I mean, clearly there is a problem between  
33 overriding people's rights and the hold-out problem. I don't  
34 know that 75% is the right number. I don't know how you would  
35 arrive at the right number.

36 **MS REBSTOCK:** Do you think that's an essential provision, though, to  
37 fix the problems that we see in transmission investment?

38 **MR REEVE:** It's our hope and -- well, I should say it's our belief,  
39 but it is our opinion that the fact that the 75% hopefully  
40 becomes irrelevant, the fact that there is a provision by which a  
41 party may be affected by a decision that may benefit them means  
42 that they now have an incentive to participate in the decision-  
43 making process.

44 **MS REBSTOCK:** Can I just go on to another point. In your submission  
45 on page 8, in the middle paragraph on that page you say that you  
46 believe that a Crown EGB is not sufficiently different from the  
47 status quo.

48 Yesterday when we heard from the applicant, and again I  
49 apologise if I'm paraphrasing, it was suggested that during the  
50 development of the proposed arrangements we've been through a  
51 period where the industry has been behaving in the way that might

*Mighty River Power*

1 be quite similar in terms of the dynamics with Government to what  
2 we might expect under an industry EGB.

3 You seem to be expressing quite a different view here, and I  
4 just wondered if you wanted to comment on that.

5 **MR REEVE:** I'm not really clear, sorry. I wasn't clear on what  
6 you're asking.

7 **MS REBSTOCK:** You may not have been here for the discussion  
8 yesterday, but let's rephrase it. You indicate that you think  
9 the status quo in the Crown EGB would be similar.

10 Can you tell me why that is?

11 **MR REEVE:** I guess I should start by saying that we can't guarantee  
12 that it wouldn't be similar, but we're not sure of that.

13 We are genuinely concerned that the counterfactual wasn't  
14 defined. We also can see that, for the reasons submitted by EGB,  
15 the Crown EGB is likely to be cognizant of its liabilities, it is  
16 likely to respond to advice it is given, and from that point of  
17 view that situation isn't significantly different from the one  
18 that we have now.

19 **MS REBSTOCK:** When you say -- what sort of advice are you referring  
20 to?

21 **MR REEVE:** It comes back to our comments about information asymmetry  
22 and resource asymmetry. So in competing opinions on advice we  
23 submit that the system operator will always have an advantage  
24 over other parties.

25 **MS REBSTOCK:** Can I just ask you a little bit about Mighty River's  
26 participation in working parties. I assume you participate in a  
27 great number of working parties?

28 **MR REEVE:** Yes.

29 **MS REBSTOCK:** Can you tell me whether Mighty River -- what Mighty  
30 River Power has done in cases where there was clear financial  
31 loss possible from a decision, a rule change. Have you ever  
32 decided to vote for a rule change that would lead to a clear  
33 financial loss for Mighty River Power?

34 **MR REEVE:** There probably hasn't been a case where there's been a  
35 clear financial loss. There's probably been cases where, on  
36 balance, we might have expected to have generally been  
37 detrimental.

38 We don't quite view it that way necessarily though, because  
39 we do believe that it's in our long-term best interests for a  
40 long-term stable market and, therefore, we do not argue against  
41 fundamentals. We accept that any potential short-term loss is a  
42 long-term gain in terms of stability for investment.

43 In terms of a specific example, it may not be a very good  
44 one, but I'm aware the example was used yesterday of frequency  
45 standards and it was suggested that there were some parties that  
46 might have perceived that they might be better off by imposing  
47 those standards.

48 I guess Mighty River Power would be one of those parties  
49 because our plant is largely frequency tolerant. However, there  
50 was no -- first of all, it would not have been sensible for  
51 Mighty River Power to oppose that, but it also would have been  
52 consistent with our goal of having a long-term sustainable

1 competitive market to oppose it. And we not only supported the  
2 proposal but we also participated in the Working Group that came  
3 up with the new standards.

4 **MS REBSTOCK:** So when you think about your position on any given  
5 issue, you evaluate it in terms of the net benefits to the  
6 industry as a whole, regardless of the direct costs to the long-  
7 term -- even the long-term interests of Mighty River Power, in  
8 terms of purely the financial costs of the -- to your own plant  
9 and equipment?

10 **MR REEVE:** The long-term financial costs of any proposal in the  
11 electricity industry are very hard to quantify. So from that  
12 point of view the policy is to always support fundamental market  
13 outcomes, fundamental engineering outcomes, security outcomes,  
14 and to rely on being good at business over the long-term.

15 **MS REBSTOCK:** You must impose on that some sort of financial  
16 constraint?

17 **MR REEVE:** We don't, and even if we considered that we could, we  
18 don't believe that that would be a sustainable position to take.

19 **MS REBSTOCK:** I might come back. I'll give my colleagues a chance  
20 to ask some questions.

21 **MS BATES:** I just want to, if you've got your submissions there, at  
22 page 4, I'll read out a sentence:

23 "Mighty River Power considers that aligning the Guiding  
24 Principles more closely to the GPS is likely to reduce  
25 competition and is unlikely to lead to good policy outcomes."

26 That's the statement that's made. The question I want to  
27 ask you is, what do you see as being the difference in focus  
28 between the guiding principles and the GPS?

29 **MR REEVE:** It's our belief that the -- and what should be internal  
30 to the market -- should be economic in terms of meeting the  
31 economic parts of Government policy. The Government Policy  
32 Statement actually has some other requirements that, for reasons  
33 external to the electricity industry are robust policy  
34 requirements.

35 **MS BATES:** Could you elaborate on what those are in your opinion?

36 **MR REEVE:** An example would be renewable resources. I mean, quite  
37 clearly it's in New Zealand's, even perhaps the globe's, best  
38 interests to support renewable energy. We would submit that that  
39 kind of social policy outcome is an externality to the  
40 electricity market. We should not provide any barriers to that,  
41 but if they are uneconomic without some form of social policy  
42 intervention, then the market design itself should not be altered  
43 in a way that makes them competitive if they are to be supported  
44 in a way to achieve a social outcome, that that should be done  
45 external to the market framework.

46 **MS BATES:** And how could you do it externally to the market  
47 framework?

48 **MR REEVE:** An example for renewable energy maybe subsidies so that  
49 they are economic when they compete in the market.

50 **MS BATES:** Do you agree with the Government Policy Statement?

51 **MR REEVE:** Yes, we do. But we do believe that the requirements  
52 inside the industry EGB framework or -- sorry, even the Crown EGB



*Mighty River Power*

1 framework should only meet the economic requirements of  
2 Government policy, but should not provide barriers to the other  
3 policy requirements.

4 **MS BATES:** You were talking about asymmetry of information, that's a  
5 theme that the applicants pursue as well. You said that you  
6 thought the industry EGB would have access to greater information  
7 than resourcing Crown EGB. I'd like you to elaborate that a bit  
8 because under the Electricity Amendment Act, when the EGB is  
9 making a recommendation it has a positive duty to consult with  
10 the industry players, and I'm wondering why it is that the  
11 industry players would be less likely to make the information and  
12 resources available that supports the various cases they want to  
13 put forward; why they would be less likely to provide that  
14 information to a Crown EGB than an industry EGB?

15 **MR REEVE:** Our opinion, and it is our opinion, is that the framework  
16 for the Crown EGB isn't clear. It's possible that, as it is an  
17 agent, a direct agent for the Government, and potentially the  
18 linkages within the Ministry of Economic Development and various  
19 other parts could be substantially different to the industry EGB,  
20 whose role is to represent the industry and wider consumer  
21 concerns directly.

22 Our opinion is that it is more likely that, in terms of  
23 confidential information, that industry participants would be  
24 more candid with an industry EGB than with a Crown EGB.

25 **MS BATES:** Even if the information was necessary to support a  
26 particular argument that an industry player wanted to put forward  
27 to a Crown EGB to prevent it operating in a certain way; that's  
28 the one which I have difficulty with?

29 **MR REEVE:** I think in that particular case, where it was that clear,  
30 then there would be no difference but I think most cases tend to  
31 be more complicated in that where the risks and benefits were not  
32 clear, then one would be -- I think one would be preferable to  
33 the other.

34 **MS BATES:** Okay. Thank you.

35 **CHAIR:** Could I just follow up on a couple of points that Denese  
36 Bates was leading into, I think.

37 You say in the submission in a couple of instances that the  
38 ability of the system operator to influence wider outcomes is  
39 likely to be a feature of a Crown EGB.

40 Now yourselves, Genesis and Meridian are all State Owned  
41 Enterprises. Do you put the system operator's ability to  
42 influence a Crown EGB outcome more at the information and  
43 position of the system operator rather than its ownership  
44 structure or, from an ownership point of view, are you all the  
45 same?

46 **MR REEVE:** From an ownership point of view we're all the same, but  
47 from a class of participant point of view we're quite different.

48 In some areas the three generator SOEs may have alignment of  
49 interests. On a lot of issues we actually have different  
50 opinions.

51 Given that the system operator, and even as transmission  
52 asset owner -- I mean, we do agree that they are independent from

**Mighty River Power**

1 energy concerns, therefore, and something where there is a clear  
2 conflict of interest in the energy market the generator SOEs  
3 would clearly be seen to have a conflict of interest. The system  
4 operator's opinion in that context would probably carry more  
5 weight.

6 **CHAIR:** Following that on, you make the point that being system  
7 operator and asset owner produces a conflict, I think, from an  
8 ownership point of view or an operational point of view.

9 Under which model -- the counterfactual or the applicant's  
10 model -- do you think that there might be effective  
11 contestability for system operation, and then, following through  
12 some of the points that were made yesterday, one of the themes  
13 was that system security under the Crown model could well prevail  
14 over market dynamics.

15 So, I guess, there are two questions: The conflict you  
16 mentioned here between system operator and asset owner and the  
17 contestability of system operation; and then the second point,  
18 whether indeed systems security issues are likely under a Crown  
19 model or under the counterfactual to outweigh a number of the  
20 objectives that you and others have mentioned.

21 **MR REEVE:** Yes, I think that there are a number of reasons why  
22 security issues are likely to be thought of ahead of other  
23 issues. Largely security issues will tend to be engineering  
24 based decisions and will generally be reasonably clear. Other  
25 issues will have some element of balancing, competing economic  
26 and also commercial interests and will generally be much less  
27 clear and, therefore, inherently more difficult.

28 Our belief is, for the reasons that we've already explained,  
29 that generally we think that it's more likely that industry  
30 participants will be more candid with an industry EGB than a  
31 Crown EGB and, therefore, the industry EGB will be more informed  
32 in terms of the potential conflicts that the system operator  
33 might have with the transmission asset owner than a Crown EGB,  
34 and will be more aware -- will be -- we suggest that that will  
35 make them more likely to force prior to any contestability of the  
36 system operator, a clearer division between the transmission  
37 asset owner and the system operator, which over time would make  
38 it easier for the system operator to be contestable.

39 **CHAIR:** I guess as a final point, you see an industry EGB will give  
40 people like yourselves more ability to balance what you might  
41 determine as an advantage under the system operator under a Crown  
42 model. You make two or three cases in your submission, you make  
43 it fairly clearly the view that the system operator in the Crown  
44 model is likely, I suppose, to run and cut; and my question is,  
45 why can't companies like yourselves under that model also produce  
46 the same inference under the Crown EGB to counter that. You seem  
47 to be saying under the industry model you could and under the  
48 Crown model you couldn't?

49 **MR REEVE:** [pause]. I'm just trying to remember --

50 **CHAIR:** If you want to think about it, you can come back to the  
51 Commission as long as it was reasonably prompt, that's all.

*Mighty River Power*

1 **MR REEVE:** Well, I'm just not sure that I understand your question  
 2 correctly, but I think what you are saying is -- or I think our  
 3 answer is -- oh, no, we better come back to you. I don't  
 4 understand the question.

5 **CHAIR:** I'll just rephrase the question.

6 You're making, in your submission in a couple of places, the  
 7 ability of the system operator to have the, if you like, say in  
 8 the Crown EGB model.

9 All my question is, given that the three Crown generators  
 10 plus the other one, Contact, are all fairly big organisations and  
 11 all over 21, why wouldn't you be able to bring a countervailing  
 12 influence on the Crown EGB?

13 **MR REEVE:** Okay, sorry. Our belief is that the Crown EGB would be  
 14 more susceptible to lobbying, and we believe that history has  
 15 shown that the system operator and the transmission asset owner  
 16 are far more effective at lobbying than mission participants.

17 I mean, I don't think I can -- I can come back to the  
 18 opinions on why that is, but we believe that because the industry  
 19 EGB would be less prone to lobbying, that that's more balanced.

20 **CHAIR:** So you don't see yourselves as -- well, it's a hard one to  
 21 phrase -- as efficient at lobbying as the system operator? It's  
 22 as simple as that.

23 **MR REEVE:** Yes.

24 **MS BATES:** And so, it follows that you think the system operator  
 25 wants to hold on to being the system operator?

26 **MR REEVE:** That's the natural incentive, yes.

27 **MR CURTIN:** One of the themes of submissions against the Rulebook  
 28 has been the voting position of the big integrated generator,  
 29 retailers acting as a block and having most of the votes on most  
 30 things -- I think, is probably how it would be put -- and you  
 31 mentioned though that on a number of the issues, I think more or  
 32 less as a throw away line, I think, you mentioned a while ago,  
 33 that in a number of the instances the power industries do not see  
 34 eye-to-eye. Would you care to give us some examples of where you  
 35 have taken different positions rather than acting as a common  
 36 class of participants in the market?

37 **MR REEVE:** Do you mean any example or an example that might  
 38 specifically relate to a competition issue?

39 **MR CURTIN:** Your choice. I think, both.

40 **MR REEVE:** I can't think of one off-hand that might relate  
 41 specifically to a competition issue, but currently there is a  
 42 reasonable range of opinions on a block dispatch within the NZEM  
 43 Rules.

44 **MR CURTIN:** You'd have to help me here, what's "block dispatch"?

45 **MR REEVE:** I was aware that that might... The Rules of NZEM provide  
 46 for an outcome -- because we have a full nodal model and,  
 47 therefore, dispatch and market clearing is discrete at every  
 48 injection point in the grid, but that hydro river change share a  
 49 fuel resource across stations at different locations, there is a  
 50 potential productive inefficiency caused by not having the  
 51 ability to manage the resource consistent with a market clearing.

1           The Rules provide for that by saying, providing that there  
2 isn't a substantial price effect that you can benefit from, or  
3 that it doesn't compromise system security, that you can agree to  
4 treat those stations -- you can aggregate those individual  
5 stations, batch instructions into a block and then manage your  
6 resources in the best way you see fit.

7           It's fair to say that -- well, it's my opinion that Genesis  
8 and us have significantly different opinions on whether that's  
9 wealth maximising provision in the Rules.

10 **MR CURTIN:** Thank you.

11 **MS REBSTOCK:** I just wanted to ask you one more question. Much of  
12 what you said, and please tell me if I'm wrong, seems to suggest  
13 that you find benefits in an industry EGB primarily because it  
14 will shift, possibly in your view balance, in a sense shift  
15 influence in the industry in a relative way away from Transpower  
16 and towards other industry participants; is that fair to say? I  
17 mean, a lot of what you have said is about rebalancing that  
18 influence.

19 **MR REEVE:** I think I just modify it slightly to say, balance it more  
20 towards industry participants and consumers.

21 **MS REBSTOCK:** If that's the case, how will consumers capture any of  
22 the benefit of that rebalance; why will they, necessarily?

23 **MR REEVE:** We believe that because there is an integrated decision-  
24 making between transport and the energy market that the delivered  
25 cost of energy to consumers is higher than it needs to be.

26 **MS REBSTOCK:** Does it make you wonder why the consumers seem to have  
27 very significant concerns with this proposal and have put in  
28 submissions to us that, even where they accept the benefits of an  
29 industry over a Crown EGB, they're uncomfortable with the  
30 particular proposal. Does that cause you concern, that the  
31 consumers don't seem to be able to see that those benefits are  
32 going to flow through to them under the current proposal?

33 **MR REEVE:** Yes, it does cause us concern.

34 **MS REBSTOCK:** Can you tell me from your experience in the industry  
35 why you think that perception is there?

36 **MR REEVE:** I can't answer that at this time. If you'd like us to  
37 consider that and provide a response we'd be happy to do that.

38 **MS REBSTOCK:** It is a bit of a puzzle that if these benefits, if  
39 there's a relative shift in influence in the industry through  
40 this proposal that will yield net economic benefits, why do the  
41 consumers not perceive a benefit from it? I'm generalising, but  
42 I don't see a lot of support from the consumers to this proposal.

43 **MR REEVE:** From an economic point of view -- not that I'm an  
44 economist -- but I'm not generally surprised because as we're  
45 suggesting the balancing and competing interests of dynamic and  
46 allocative efficiency need to be balanced, and we have submitted  
47 that we would generally -- and it is a generalisation -- but we  
48 would generally err on the side of dynamic efficiency and we  
49 suggest that consumers will generally err on the side of  
50 allocative. So, it's not perhaps surprising it's a polarisation  
51 of opinions on balance.

1           In terms of why we can't actually agree on balance, I think  
2 that might be part of the history of the electricity industry to  
3 a certain extent. I think it's fair to say that the evolution of  
4 the electricity industry in New Zealand, and probably worldwide,  
5 has not been pain free; has been a fairly rocky road, and I think  
6 there is bound to be quite a lot of nervousness from all parties  
7 that have an interest in the market.

8 **MS BATES:** Just following up on that. In your opinion, would a  
9 Crown EGB be more likely to favour consumer interests than an  
10 industry EGB?

11 **MR REEVE:** I don't think that it would specifically be more likely  
12 to favour consumer interests. Our fear would be that it tends to  
13 favour short-term interests and because the nature of the  
14 industry is that investments are long-term, that would generally  
15 be to the detriment of dynamic efficiency.

16 **MS BATES:** Do you think it would be more susceptible, a Crown EGB,  
17 to consumer lobbying than an industry EGB?

18 **MR REEVE:** We think it would be generally more susceptible to  
19 lobbying, yes.

20 **MS BATES:** Consumer as well as Transpower?

21 **MR REEVE:** Yes.

22 **CHAIR:** Any other points, staff members?

23 **MR ADAMS:** Can I go back to your example you gave about the release  
24 of bids and offers. That has been put forward by those  
25 supporting the application as an example of where self-governance  
26 -- under self-governance arrangements you have a pro-competitive  
27 rule change being introduced and by those who oppose there have  
28 been examples where pro-competition rule changes have been  
29 logged. Without going back into the history of it, I was  
30 wondering how you see that question being dealt with differently  
31 by an industry EGB or a Crown EGB? Would you be likely to get a  
32 faster and a more optimal outcome with one or the other?

33 **MR REEVE:** I think it's hard to make a call on that. I think, I  
34 think it might be a slight bit of a cop-out, but it's never been  
35 clear that that is a net benefit, and in the end the proposal on  
36 the release of bids and offers was largely qualitative and not  
37 quantitative in any way.

38           To the extent that that one would have been perhaps  
39 difficult in both situations, I'm not sure I can answer that  
40 meaningfully, to be honest.

41 **MR ADAMS:** I mean, clearly there is a strong Government influence in  
42 the position NZEM has currently got to release of offers. Does  
43 that suggest that the Government would impose similar sort of  
44 pressure on an industry EGB?

45 **MR REEVE:** Oh yes, I believe so.

46 **MR ADAMS:** And so that outcome would really mirror that if the  
47 Government's making the decision itself in a Crown EGB situation?

48 **MR REEVE:** I believe so. I think that the bids and offers one is  
49 probably not -- is not our greatest fear. I mean, obviously we  
50 are concerned if wealth maximising rule changes don't occur, but  
51 sometimes that isn't clear. I think that our concern with the  
52 Crown EGB -- I mean, the key thing about the bids and offers is

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1 that it did go through a lot of due process. Our concern would  
2 be that, in a proposal that was not clear, that a Crown EGB may  
3 rush a decision where the industry EGB may be frustratingly slow,  
4 but will nevertheless have been more considered.

5 **CHAIR:** Okay, any questions you'd like to ask of us? We've been  
6 grilling you for the last half hour?

7 **MR REEVE:** No, I'm quite happy, thanks.

8 **CHAIR:** Thank you very much for making the time and if you have any  
9 further comments we'd probably need them early next week so we  
10 can circulate them to other parties to comment on. Thanks for  
11 coming down and making the time to speak to us. [**Pause**].

12 **CHAIR:** According to my timetable Mr Hogan is scheduled for 10.30,  
13 so I think we'll take a break now and convene just before 10.30.  
14 Thank you.

15

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17 **Adjournment taken from 9.55 am to 10.30 am**

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**PRESENTATION BY TRANSPOWER**

1  
2 **CHAIR:** It looks like one or two people have arrived to come  
3 specifically to hear Professor Hogan. So, even though it's a  
4 little early, we'll get underway.

5 I'd like to introduce Professor Hogan who, among other  
6 assignments, is Professor of Public Policy and Administration at  
7 the Kennedy School of Government at Harvard. It goes without  
8 saying, he's had a lot of experience in electricity markets and  
9 has written extensively on the subject. So, without further  
10 hesitation, I now ask Professor Hogan to talk to us, please.

11 **PROF HOGAN:** Thank you very much, Mr Belgrave. It's a pleasure for  
12 me to be here and I think what you're engaged in is an extremely  
13 important test. I also want to thank you for accommodating the  
14 schedule. I know that I'm appearing a little bit out of what  
15 probably would have been your preferred order but I'm grateful  
16 for your accommodation in that regard.

17 I'm appearing here today at the request of Transpower, but  
18 I feel I should emphasise, as I always do whenever I speak to  
19 groups, that I don't speak on behalf of anyone else; these are  
20 just my own opinions and views and, importantly, I'm involved in  
21 a large effort in the United States called the Harvard  
22 Electricity Policy Group, and part of the arrangement with that  
23 group is that I always remind everybody that I don't speak on  
24 their behalf, and I want to do that here.

25 I thought as my introductory comments to elaborate slightly  
26 on the written materials that I sent you, that it would be  
27 useful for me to quickly summarise a little bit about my own  
28 history and then to address three topics that I think are  
29 relevant to the discussion here.

30 One is this question of industry self-governance; the  
31 second is the nature of industry decision process from my  
32 experience and the experience particularly in the United States;  
33 then, finally, the question about infrastructure, investment and  
34 some of the problems that might be encountered here and that  
35 we've encountered elsewhere.

36 As to the history of my experience, I won't go into  
37 everything in detail. I've been involved in electricity, in  
38 particular market design and before that dealing with energy  
39 restructuring in general. In the 80s I was involved in the gas  
40 industry liberalisation in the United States. In the late 80s I  
41 started working on the electricity problem with some of the  
42 utilities in the United States. I was also involved in 1989 and  
43 90 in England and Wales with what later became the national grid  
44 company as an adviser in that process. I had extensive  
45 involvement in the early days in the mid-90s in the California  
46 process, which I will talk more about later, and then was not  
47 involved for a while, but then have been back actively engaged  
48 in their sort of second round of reform process.

49 I was a central participant in the process in what's known  
50 as PJM; the PJM interconnection which is the sort of mid-  
51 Atlantic states of the United States and starting in about  
52 1994/1995 and continuing to today.

1 I also spend a great deal of time, and am still working  
2 with the New York independent system operator in the reform of  
3 the markets there.

4 I spent a good bit of time in 1998 and later dealing with  
5 the problems that have cropped up in New England, and I'm going  
6 to talk about that in a moment because I think it's actually  
7 relevant to some of the discussion that you have had here.

8 I have had less central involvement, but a substantial  
9 contact, with developments in Ontario working with the Regulator  
10 in Mexico; discussing this with various parties in Spain and  
11 Japan; the extensive being an activity that's been underway in  
12 the Midwest in the United States; Australia to some degree with  
13 GPU Powernet in Victoria; and advising the Regulatory Commission  
14 in Texas on the development of their market.

15 My involvement in New Zealand actually began in the early  
16 1990s when I was invited along with some of my colleagues from  
17 the United States to work with ECNZ at the time, when it was  
18 under the leadership of Roderick Dean, and participated in what  
19 I would characterise as an extensive and sustained series of  
20 discussions, where I met people like Bob Thomson and Keith  
21 turner and such in that Conference Room at the ECNZ headquarters  
22 where we were debating these issues about electricity market  
23 design. I have been involved subsequently as an adviser to  
24 Transpower pretty much on a continuous basis since then, dealing  
25 with issues of market design, particularly things like  
26 locational pricing and financial transmission rights.

27 So, I don't characterise myself as an expert in the context  
28 of New Zealand, but I'm familiar with much of what's going on in  
29 New Zealand, and I believe that it's actually quite important  
30 what's happened here.

31 One of the reasons that I am here today, not only because I  
32 was asked, but I often cite New Zealand as a leader in  
33 electricity market design in discussions elsewhere in the world  
34 and I'd like to continue to do that, so I hope that that does  
35 continue.

36 There's much in the presentation that I've heard over the  
37 last couple of days and read in the materials that I generally  
38 agree with. I'm not going to dwell too much on the things that  
39 I think where there is agreement.

40 I was struck on the first day in the morning in David  
41 Caygill's presentation by his reference to Helmut Schmidt; you  
42 recall it was something which I noted down as "preferring as  
43 much market as possible and as much regulation as necessary",  
44 which I thought was a rather succinct way of summarising the  
45 issue.

46 It's a sentiment which I share and it is an important idea;  
47 it's the distinction between appropriate and inappropriate  
48 regulation. It's a mistake, and I think it happens to some  
49 extent to the discussion in the documents that I have seen, but  
50 I think it's a mistake to set up a sharp dichotomy between  
51 markets and regulation.



1 I think there are parts of the electricity industry and the  
2 electricity sector that work well with markets if they're  
3 designed properly, and you can leave investment decisions and  
4 operating choices and so on to the individual participants in  
5 the market.

6 Then, I think, there are parts of the problem, this  
7 particularly has to do with setting up the market rules, where  
8 regulation is necessary. I'm going to try to be more --  
9 elaborate on that point about what I think is important.

10 So, it's not a simple dichotomy and it's actually a great  
11 challenge to define what is the appropriate regulation both in  
12 level and in form.

13 Another point on which I do agree is the character of the  
14 electricity product and the electricity market which was  
15 described by David Caygill, that there is something special or  
16 unique about electricity, that there are very strong  
17 interactions in the electrical network which create large  
18 externalities, and that is an important observation which I  
19 wholeheartedly endorse.

20 He also said he came to that view reluctantly, because he  
21 doesn't like arguments about markets, we're special, which you  
22 hear often. I share that experience. I came to that view  
23 reluctantly as well. My experience in natural gas, I heard the  
24 same arguments there and I thought it basically wasn't true, and  
25 I think the evidence has shown that you could have a natural gas  
26 market in the US which has been quite successful.

27 When I started looking at electricity it took me a while  
28 but I finally became convinced that this was an important  
29 feature which had profound implications for what you could do in  
30 the design of markets.

31 Secondly, that there's strong interaction that takes place  
32 in the transmission grid in the short-run is something about  
33 which we don't have very good intuition. The analogies that we  
34 make to other markets and other services don't hold up, and so  
35 it presents a special challenge in the design of markets.

36 You sometimes hear even in the discussion in this process,  
37 about simple definitions of transmission service as though it  
38 can be defined separately from energy markets, for example, and  
39 I think that's actually impossible. I have been involved in  
40 discussions in New Zealand where the transmission system and the  
41 transmission provider were analogised to a trucking company, and  
42 like a trucking company it should serve its customers. I think  
43 that's a profoundly misleading metaphor and analogy and not a  
44 proper, and leads us astray.

45 This presents a challenge for market design but it's a  
46 challenge that New Zealand has met, and basically the structure  
47 that I think is necessary is what you have. What is becoming  
48 known in the United States as the standard market design, and  
49 this is built around the co-ordinated spot market which is run  
50 by the system operator based security constraint, economic  
51 dispatch with locational pricing.

1           There are some features that are missing from New Zealand,  
2 particularly these financial transmission rights, but I don't  
3 think there's any disagreement on that point, at least, between  
4 David Caygill and myself, so I won't dwell on that.

5           This is a very good design that exists in New Zealand and  
6 it's one that you should be proud of and justifiable, and, as I  
7 say, I have often said that New Zealand is in a leadership  
8 position in this matter. I still think that's true with the  
9 caveat that I mentioned.

10           However, I do have a different view about how that design  
11 evolved in New Zealand. I think it's certainly not my  
12 recollection, and not my view, that this emerged through  
13 extensive negotiation in a voluntary process involving industry  
14 participants, quite the contrary. What I recall is that it  
15 emerged as a conscious effort led by Government and Government  
16 owned entity, a State Owned Enterprise, ECNZ and its subsequent  
17 descendents, particularly in Transpower, to develop a market  
18 design which was very much in the public interest and not driven  
19 by negotiation that was motivated by the commercial interests of  
20 the respective parties.

21           In my recollection, that design was pretty much as you have  
22 it now in the critical elements, existed well before extensive  
23 discussions with the industry were underway. What became --  
24 what happened was that the industry slowly either accepted or  
25 acquiesced to the view but not that it emerged from that  
26 process.

27           My personal view, particularly given experience elsewhere,  
28 is that absent the leadership of Roderick Dean and his  
29 colleagues at ECNZ, the situation could easily have been quite  
30 different here.

31           Secondly, the characterisation of the current structure and  
32 governing structure under MARIA and NZEM, MACQS, the Common  
33 Quality Rules, I think it's improper to characterise that as a  
34 voluntary system. It's voluntary -- you can decide whether you  
35 are under MARIA or NZEM, but it's not voluntary that you have to  
36 be under one or the other, and they are internally consistent  
37 more or less in what they do. So I think of them as a package,  
38 a single umbrella much like the single set of rules under RTOs,  
39 or systems in the United States like PJM which are not voluntary  
40 in that sense. I think that's a very important -- frankly, I've  
41 always worried about the governance relationship in New Zealand  
42 because there was this delicate balance of the rhetoric being  
43 that these were voluntary agreements being different from the  
44 reality, and I often worried that something would change and one  
45 of the agreements was inconsistent with the other and then the  
46 whole system would start unraveling as has happened in the  
47 United States.

48           It hasn't happened here, happily, but I frankly have always  
49 worried about it.

50           And I worried about it because I think that my sense of the  
51 situation in New Zealand is that it's been very much here, it's  
52 been very much like it is elsewhere, which is that the standard

1 market design is constantly under attack by market participants.  
2 Debates about the treatment of congestion and lost rentals,  
3 whether or not and how to implement financial transmission  
4 rights, the rules for dispatch and pricing, and even the absence  
5 of things like initiatives for market power mitigation. These  
6 are problems that are -- exist here and they exist elsewhere, so  
7 it's not as though we shouldn't be concerned about the  
8 governance relationships.

9 The success you have had so far is commendable, but I'm  
10 just giving my view that I've always worried about it a little  
11 bit because I thought the rhetoric wasn't quite consistent with  
12 the reality, and you're not alone in that as I will come to  
13 describe in a moment.

14 So I think thinking forward about the governance process is  
15 a good idea, rationalising what has been done is a good idea but  
16 it's important to make sure that when you do, it makes things  
17 better.

18 That's a little description of the history. Let me say  
19 something about the first topic, which is self-governance.

20 **MS REBSTOCK:** Can I stop you there, if that's an accurate break on  
21 the history. I understand the point you are making about the  
22 history of ECNZ taking the lead in setting up the Rules that we  
23 currently operate under.

24 But ECNZ, I think the counter-argument or not -- maybe not  
25 a counter-argument, but the point, that most people here would  
26 say that the rhetoric might have been whatever the rhetoric was,  
27 but it was an SOE and that SOE never claimed to be operating in  
28 anything more than in the commercial interests and had no  
29 obligation to do anything more than that.

30 So, because I suspect that's the point that would be made  
31 in response I'd like your comment on that, because I think this  
32 SOE model in New Zealand is quite different than anything that  
33 you might find in other jurisdictions, and I often find that  
34 people from other jurisdictions don't understand it and they  
35 sometimes don't understand that even though they are Government  
36 owned agencies they do follow the commercial interest of the  
37 organisation, that they were given a freehand to do that in most  
38 cases.

39 I agree that it's still bound by the fact that they're  
40 Government owned, but there must be some element of balance that  
41 was struck in there, where the commercial interests were very  
42 strongly allowed a free play.

43 **PROF HOGAN:** Well, it's a good question and it anticipates some  
44 things I'd say about New York, for example, but let me be  
45 specific about that timeframe and the ECNZ.

46 I am aware -- I'm certainly not an expert on all of them,  
47 but I'm aware of the points you're making. It is conceivable  
48 that the State Owned Enterprise ECNZ at the time could have had  
49 strong commercial incentives which dominated their discussions.

50 It's also conceivable that the utilities in the state of  
51 New York, which I will come to talk about as an exception, what  
52 happened in the United States could have been dominated by their

1 commercial interests, for different reasons in each case, and I  
2 will emphasise the experience here with ECNZ.

3 My observation, and I would characterise my observation as  
4 extensive in terms of this interaction, was that in the  
5 individuals that you had running the organisation and embodied -  
6 - and I'll give a lot of credit to Roderick Dean in this  
7 regard -- you had people who took a very long view about what  
8 was in the best interests of New Zealand. And make no mistake  
9 about it, that the process that you ran questioned constantly  
10 what is in the best interest of New Zealand, what is in the best  
11 interest of maximising the benefit to the country as a whole,  
12 and questions about the narrow interests such as they were of  
13 ECNZ were very much reduced; it's not that they weren't  
14 discussed about what it would mean but the dominant view was  
15 that they had a -- almost a moment in history here because  
16 something dramatic was going to take place and they had an  
17 opportunity to do something and they wanted to do the right  
18 thing.

19 **MS REBSTOCK:** Isn't it possible that that dynamic arose inside ECNZ  
20 because at that time they had the generation, they had the  
21 transmission network; having Transpower in-house at that time  
22 gave them that long-term perspective?

23 In that context it was consistent with their interests and  
24 that interest was represented in the discussions, but that was  
25 because of the nature of that business at that time. Maybe it  
26 was because of that and not necessarily because they were a  
27 Crown owned enterprise, and in that sense we still maintain that  
28 range of interest; it's just not under one body now.

29 **PROF HOGAN:** Well, I think that's quite possible, and it's  
30 consistent with the point I would have made about New York.  
31 What happened in New York, just to anticipate it, is the  
32 utilities there; they had a stakeholder process that I'll talk  
33 about and there was voting arrangements and so forth, but to get  
34 right down to it the utilities were in charge for the initial  
35 design phase, not later, but in setting up the initial system  
36 very much in the way that ECNZ was.

37 They took a view that the best outcome for them was  
38 something that worked well. So, they felt their interests were  
39 aligned with the public interest. In the narrow places where  
40 there might be some conflict, they were better off if they  
41 didn't try to jiggle the system to benefit themselves and so  
42 were more interested in a sensible design.

43 In part it's just -- the unique situation was  
44 personalities; in part it's a cultural phenomenon I think in the  
45 case of these utilities which have, because of the way  
46 regulation worked in the United States, you had a dichotomy  
47 between the economic incentives and the engineering operations;  
48 there was no hope that pricing or other kinds of incentives like  
49 that would affect operations, because they were completely  
50 disconnected under the regulated system.

51 And so, the engineers who were typically running these  
52 companies used engineering objectives, engineering principles

1 and an engineering ethic in order to decide on how to do things.  
2 That ethic has a very strong public interest component to it.  
3 It's a cultural phenomenon which is a wasting asset in the  
4 United States that -- and we're benefitting from it to some  
5 extent, but it's slowly going away because of the introduction  
6 of all these commercial tensions now with the restructuring of  
7 the industry.

8 It's a danger -- and I think, frankly, New Zealand has been  
9 lucky in this regard because I think that ethic exists in  
10 Transpower, and they continue to act that way. It's an asset --  
11 I can't guarantee it will be there five years from now, but it's  
12 my personal observation that it's there now, and this is a good  
13 thing, and I see a direct connection back to the early days when  
14 I was first involved in these conversations.

15 **CHAIR:** You make the point in your paper too, on page 5, which I'm  
16 sure Transpower's read anyway, the same point. So, it's an  
17 interesting perspective.

18 **PROF HOGAN:** So the first of the three topics I want to address  
19 besides this history, which is important, is self-governance and  
20 the experience in the United States or industry self-governance.

21 As I mentioned briefly, but I'll elaborate, the  
22 United States is a complicated story. We have 50 states with  
23 Public Utilities Commission's of various types in the States  
24 that regulate part of the electricity system. We have a Federal  
25 Energy Regulatory Commission that's responsible for other parts.  
26 For the most part these Commission's are appointed, typically by  
27 the Governor of the State, and they're appointed at terms as  
28 Commissioners. In some States they're actually elected directly  
29 so they're not appointed. North Dakota and Mississippi are  
30 examples where they're elected and effectively it's a political  
31 stepping stone.

32 Typically the Governor -- even though the individuals are  
33 appointed to terms -- the Governor has discretion over who's the  
34 Chairman of the Commission at any time and can change that  
35 designation, so the Chairman may stay on a Commission but not be  
36 the Chair any more, and the Chairman is very powerful in most of  
37 these situations. So there's a layer of regulatory institutions  
38 and overlap of this process.

39 What's relevant for the discussion here in New Zealand  
40 today is, what happened essentially from about 1992 to last  
41 year, I would say, or slightly earlier in the United States as  
42 part of electricity restructuring, we passed the Energy Policy  
43 Act in 92 which set up the notion of introducing some  
44 competition and the Federal Regulators adopted some broad  
45 principles about how this would go forward. Regulators, in  
46 particular California, did similar studies and made  
47 pronouncements about broad principles.

48 But then it was the tenor of the time that this should be  
49 an industry-driven process, the term that's used in the  
50 United States is stakeholder as opposed to industry led, but  
51 it's the same idea. And that what should happen is that the  
52 stakeholders should get together and discuss through extensive

1 Working Groups and negotiation and develop a design for what the  
2 market rules should be, for what the market institutions should  
3 be, and how all of this would operate. Basically the role of  
4 the Regulators was to defer to the industry. So they stepped  
5 back and didn't participate in this process to the extent of  
6 refusing to attend the meetings. So, they wouldn't even be  
7 there to listen to the discussion about what was being  
8 developed.

9 Then the proposals would come forward from the industry, be  
10 presented to the Regulators for formal approval, but the  
11 attitude was to let -- in the words of the Regulators -- "let a  
12 thousand flowers bloom". So, if we got a design and we had  
13 consensus from the industry about what to do in New England, or  
14 what to do in California and so on, we would accept it and we  
15 might tweak it around the edges slightly but not very much. And  
16 to the extent that they did tweak the Rules at the margin, they  
17 tended to be focused on changing governance processes to change  
18 the voting weights for the different parties, but not to get  
19 into the admittedly technocratic details of what you would call  
20 the Rulebook about market design issues.

21 The experience there then gives us a lot of evidence about  
22 what happens when you have an industry led negotiation to  
23 develop the Rules for the market. Because, as a practical  
24 matter the Regulators did nothing, or very little. That  
25 presented, as it turns out, a problem.

26 In all but one case -- and I mention the case of New York -  
27 - the result has been very inefficient designs that were  
28 defective, that were anti-competitive and/or that resulted in  
29 interminable delay in the development of anything at all, which  
30 is still true in many parts of the United States.

31 The exception I mentioned of New York, and the Regulators  
32 have now taken a view that this was just a bad idea, and a --  
33 and at enormous cost to the country. The cost is measured in  
34 something far more than cost-benefit analysis, although nobody  
35 would want to defend what has happened as being good. The cost  
36 is really -- in the whole fundamentals of the exercise. I would  
37 say it's not at all clear that we're going to be able to proceed  
38 to the end to get a successful working market going in the  
39 United States and sustain it, and the jury is out on that  
40 because the popular opinion has been inflamed by what has  
41 happened as a result of the mistakes that were embraced, in some  
42 cases unanimously, by the industry participants.

43 Can I illustrate this process with two cases. One is the  
44 California wholesale market design, because you can't go  
45 anywhere in the United States today without talking about  
46 California. The second case is New England, which is not as  
47 well-known but is quite relevant for your conversations here.  
48 I'd be happy to talk about PJM and other places as well, if you  
49 want to ask questions about that.

50 California and wholesale market design: Let me say that  
51 there was ample blame to spread around in California. There was  
52 a failure of regulation, and a failure by the industry. It was

1 a catastrophe. There's nothing good about what happened in  
2 California, everything went wrong.

3 I'm going to concentrate on the part which is relevant  
4 here, which is the wholesale market, in setting up the Rules and  
5 the institutions for the wholesale market in California, which  
6 is different than the problems that happened in the retail  
7 market, which led to a lot of the pricing problems and so on,  
8 which has been mentioned here.

9 The Regulators failed in dealing with the retail market  
10 because they embraced the industry's proposal, for that as well,  
11 but let me talk about the wholesale market design in setting up  
12 the Rules and institutions.

13 Broadly speaking, what happened was in 1993 and 94 the  
14 California Public Utilities Commission, responding to the local  
15 pressures and to the new Energy Policy Act, started a Commission  
16 driven process to rethink how they would introduce competition  
17 and reorganise the market in California. They published what  
18 was called a yellow book and a blue book and they had a market  
19 design, and it wasn't a bad design at all.

20 There was an extensive process that began with the  
21 stakeholders, and I was involved heavily in that working with  
22 San Diego Gas and Electric, one of the utilities there. I also  
23 spent a lot of time working with the California Commission at  
24 their request discussing these same matters.

25 That process was going forward, it was very contentious,  
26 and, as I say, the Regulators did not participate in the  
27 stakeholder process. Until there was a pivotal moment, and the  
28 pivotal moment which I have described in a separate paper which  
29 I referenced in my submission to you, the paper on electricity  
30 market restructuring that was published later -- the pivotal  
31 moment was in September of 1995 when a subset of the  
32 stakeholders in a separate conversation arrived at what was  
33 called the "memorandum of understanding", and the memorandum of  
34 understanding in 1995 included a market design which was later  
35 basically implemented, and a series of side agreements about how  
36 the utilities would be paid for their past investments.

37 That design was seriously flawed, as I said, at the time.  
38 The minute I found out about it I called everyone I could and  
39 said, "This is a big mistake, don't do this." I wrote about it,  
40 published a paper, filed Commission comments and so forth, and  
41 the summary was that it was a seriously flawed design.

42 The California Public Utilities Commission responded to  
43 this by issuing an order in December of 1995 which included 10  
44 commandments, as I refer to them in the paper I wrote. The 10  
45 commandments were very specific instructions about how the  
46 design should be implemented and, if you're familiar with the  
47 details, it undid the memorandum of understanding is what it  
48 basically did, that was its purpose and would have been its  
49 effect.

50 It was, however, promptly ignored by the stakeholders and  
51 that was the last time the California Public Utilities

1 Commission had anything to say about anything with respect to  
2 market design.

3 **MS REBSTOCK:** Sorry, can you just take us back and tell us what  
4 your basic premise was in terms of what the nature of the flaw  
5 was?

6 **PROF HOGAN:** There are several features to it but the critical  
7 element was to take the co-ordinated spot market, as you have  
8 here, run by the system operator with all of the features that  
9 it has in New Zealand, and that was part of the proposal that we  
10 were discussing at the time, it was opposed by marketers, large  
11 industrial consumers, generators and so on, that design. It  
12 took it and it split that function in two, created what was  
13 called the California independent system operator, who was not -  
14 - and it was quite explicit -- not to be involved in co-  
15 ordinating the spot market, not to get pricing information or  
16 bids, not to use any of that information in clearing the market,  
17 not to use economic dispatch in order to find the least cost  
18 solution for how to actually run the system in real time. All  
19 of that was supposed to be done by -- all of the other stuff was  
20 supposed to be done by the power exchange which would be a  
21 separate entity. The system operator was only to handle  
22 "reliability issues", and not to be involved.

23 Now, these functions, in fact, are just two sides of the  
24 same coin, they are inherently integrated. So, if you try to  
25 take them apart, you're in trouble.

26 What they did then was to -- and they recognised this --  
27 that if they try to take them apart they were going to be in  
28 trouble. In order to prevent the independent system operator  
29 from essentially recreating the spot market through its own  
30 rules, they adopted a series of regulations and principles that  
31 were called "the four pillars", the market separation rules,  
32 which imposed all of these restraints on what the system  
33 operator could do, which made it much more difficult for the  
34 system operator to do what it was supposed to do.

35 There were other features, the zonal pricing system and the  
36 like, but the critical one was the separation fallacy, which is  
37 what I wrote about.

38 **MS BATES:** Excuse me, could you just tell me what was the rationale  
39 for splitting those two functions? What was the given rationale  
40 for splitting those two functions?

41 **PROF HOGAN:** There's a difference of opinion about what the  
42 rationale is, let me give the kinds of arguments that you hear.

43 I would say the vast majority of people in the  
44 United States today would say that the rationale was that it was  
45 led by Enron, and Enron thought that it could profit from chaos  
46 and inefficiency in the marketplace and, the worse the market  
47 design, the better; and that's the dominant feel of what  
48 actually happened.

49 There is another perspective which was ideological, and  
50 that is that central co-ordination is inherently evil and it  
51 should be stopped at all costs, and that you couldn't allow the  
52 central spot market co-ordinated by the system operator because



1 it would inherently create all kinds of perverse outcomes and  
2 perverse incentives, and that decentralised was inherently  
3 better.

4 That ideological ran into the problem that you can't run a  
5 system without a system operator co-ordinating things, so they  
6 had to adopt a bunch of these crazy rules to make sure that when  
7 they co-ordinated they did a bad job and they succeeded in  
8 adopting such rules.

9 There's a third view, which is my own, actually.

10 **MS BATES:** Three views?

11 **PROF HOGAN:** My view is that the parties didn't understand what  
12 they were talking about, and that I argued at the time, and I  
13 debated this publicly with Jeff Skilling of Enron, for example,  
14 and I said to him, publicly and privately, that, "What you are  
15 proposing is not in your own interest", that, "You don't  
16 understand how complicated this system is, you are using simple  
17 analogies from the gas market, you are setting up something  
18 which is going to fail badly, and it's going to lead to greater  
19 regulation in a very negative reaction not to the outcome of a  
20 good market that you'd want." his response was, to most things,  
21 which is, I just didn't get it, but I think events have shown  
22 that my view about that was actually correct.

23 So, as I said, back to this stage; the MoU came out, I  
24 tried to overturn it, the Public Utilities Commission tried to  
25 overturn it and we both failed. Henceforth, I was unwelcome in  
26 the State and basically was not involved in the discussions  
27 after late 1995, early 1996.

28 The industry process, however, went forward and it  
29 eventually became very politicised, and one of the state senior  
30 force, a very powerful State Senator named Stephen Peace became  
31 essentially the defacto chair of this process forcing a  
32 negotiation amongst the industry participants to get the details  
33 of the design in place. They got eventually so-called unanimous  
34 support and it actually required some legislative changes so  
35 that it passed through the State legislature without dissent.

36 It was put in place in 1998 and then began the trouble with  
37 the design. The wholesale market was in trouble immediately,  
38 for reasons that were predictable and predicted.

39 The response was then, through the same stakeholder  
40 process, which was now formalised in the Rules of the California  
41 independent system operator, to develop amended rules,  
42 amendments to the Rules which were then sent forward to the  
43 Federal Energy Regulatory Commission for approval. There was a  
44 long series of amendments, I won't go through all of them, but  
45 just to say that their character collectively was that they  
46 tried consistently to honour the four pillars of the California  
47 design, and they had the collective effect of increasing  
48 administrative decisions by the system operator and creating  
49 barriers to entry to market participants.

50 It was one of those barriers to entry that finally caused  
51 the Federal Energy Regulatory Commission to stop deferring to  
52 the industry process in California, and now we have another

1 turning point. The Regulators had been approving these  
2 amendments reluctantly over this period of time, but as they saw  
3 the accumulative effect of it they got down to the new  
4 generation hook-up policy that was being developed in  
5 California, and I'm happy to get into the details, but basically  
6 it was going to impose strong burdens on new generation in  
7 entering and the Regulator said, "This can't go on. This is  
8 contrary to efficiency and competition. It's a barrier to  
9 entry" --

10 **MS REBSTOCK:** I think, actually, for us to consider the  
11 implications for New Zealand, we would need to know what the  
12 nature of those barriers to entry actually were. So, either if  
13 you can summarise them, I do think we actually have to have the  
14 detail to know what weight to give to the evidence.

15 **PROF HOGAN:** Right. Well, the problem that developed, and I don't  
16 think would develop here, this particular problem, but the  
17 reaction is what I'm talking about -- the problem that developed  
18 in this particular case was that they had the zonal pricing  
19 model unlike the nodal pricing that you have, and obviously then  
20 that means in some places the price, its too high and in some  
21 places it's too low, and there are other features of the design  
22 which created subsidies or existing generators and subsidies to  
23 locate in the wrong place.

24 What resulted there, as I'll talk about in a moment, the  
25 same problem developed in New England, was that they recognised  
26 that new generators wanted to locate in places where the system  
27 was constrained and they already had too much generation, but it  
28 wasn't recognised in their pricing methodology because they  
29 aggregated everything into these zones. So, they were ignoring  
30 all of the constraints in the pricing, but -- and then so people  
31 had an incentive to locate where it was easy to locate, but  
32 there was already too much generation.

33 The device that they came up with to deal with this problem  
34 was to require the new generator to expand the transmission grid  
35 so that the zonal grid would be closer to true and so that they  
36 wouldn't be constraining any of the existing generators. And  
37 so, they had a cost burden that would be imposed on the new  
38 generators that was not imposed on the existing generators and  
39 FERC objected to this on the grounds that it was a barrier to  
40 entry and would inhibit competition.

41 The Federal Regulator responded to that proposal, I think  
42 it was Amendment 19, if I recall correctly, that they would not  
43 allow this Rule to be put in place, which I believe is the first  
44 time that they did this. They said something which was very  
45 important at the time, because they characterised the reason  
46 that California needed this Rule for new generation hook-up, or  
47 something like it, was because the congestion management systems  
48 that they had developed, the pricing system, was "fundamentally  
49 flawed", and the design that had evolved under the California  
50 ISO, partly in response to these market separation rules, and  
51 told them to go back and redesign that system.

1           Now, the date here is critical for some of the discussion,  
2 because this was December of 1999 when this order came out, and  
3 there are two things to say about that. The first is the  
4 language, and the array of FERC language calling something  
5 fundamentally flawed is unusual, shall we say quite strong  
6 language, and something they would not ordinarily do.

7           The second is that this was well before the explosion of  
8 prices in the summer of 2000. So, people forget this because of  
9 what happened in the summer of 2000, but this market was  
10 recognised as broken in December of 1999, six months before the  
11 surprise took place, and the Federal Regulators had already  
12 directed them to do something about this.

13           The response of the stakeholders in California was to  
14 ignore this order from FERC, and to try to tweak the design of  
15 their new generation policy.

16           The Federal Regulators were frustrated by the industry's  
17 response and, so, they did something else which was unusual. In  
18 our system there's a regular process of mundane orders about  
19 filing of certain documents and so on that are just part of the  
20 normal operating things, and the FERC issues orders accepting  
21 them or something like that -- it's all, nobody ever reads  
22 these, they go back and forth. They took the next occasion  
23 where one of these documents came out in California and put  
24 right in the middle of it is this paragraph about, the  
25 management system in California is fundamentally flawed, and we  
26 directed them to go back and redesign it, and they were sending  
27 signals to California that this was a serious problem and they  
28 had to fix it.

29           As a result, finally, the stakeholder process in California  
30 constituted an effort which was called "congestion management  
31 reform", and I then got involved in that process. I organised a  
32 coalition or helped to organise a coalition that consisted of  
33 the two large consumer advocate organisations, TURN and UCAN,  
34 one utility, San Diego Gas and Electric and a couple of the  
35 independent power generators, we stylised ourselves as the  
36 reform coalition, and it gave us standing in the conversation in  
37 the stakeholder meeting, and they started to participate in this  
38 process again at that time.

39           We worked in one of these negotiations. It was basically  
40 going nowhere, and it went nowhere because the stakeholders  
41 insisted on preserving the four pillars of their market design,  
42 and I kept telling them that the four pillars were the problem  
43 and that's what they had to get rid of completely and start over  
44 again.

45           It is interesting that during this timeframe the Congestion  
46 Management Reform activity, CMR, morphed into Comprehensive  
47 Market Redesign, CMR, so that he could use the same web page,  
48 but it was indicative of the problem that David Caygill talked  
49 about, which is, these pieces are all connected and once you  
50 start trying to fundamentally redesign one part you're back and  
51 you have to deal with the whole thing all over again.

1           Then in June, and during the summer of 2000, the explosion  
2           took place with high prices, and the Congestion Management  
3           Reform or Comprehensive Market Redesign effort essentially  
4           aborted. I made a presentation to the board, the stakeholder  
5           board out there at that stage but it went nowhere.

6 **CHAIR:** Just to ask you one point there. The stakeholders were  
7           whom; generators?

8 **PROF HOGAN:** Generators, customers, distribution companies,  
9           independent power producers, these consumer advocacy groups were  
10          very important in that process.

11 **CHAIR:** Any of the grid operators?

12 **PROF HOGAN:** The California system operator serves as staff to the  
13          stakeholder process but not as directly as a stakeholder.

14 **MS BATES:** Professor Hogan, something I want to ask you at this  
15          point, so that we can assess the relevance of this whole  
16          experience to what we're looking at here is, I'm just wondering  
17          to what extent this came about, by political will or the lack of  
18          it on the part of the State Governor, because you've told us  
19          that the State Governor had the ability to appoint the Chair of  
20          the Public Utilities Commission; you later told us that in 1995  
21          the 10 commandments were produced. I assume you are in  
22          agreement, broad agreement with the 10 commandments.

23 **PROF HOGAN:** Yes.

24 **MS BATES:** But that somehow the industry was able to ignore this  
25          and go on and design a market which was not in accordance with  
26          the 10 commandments.

27           Then you said to us that the chair -- and I think this is  
28           what I want to ask you -- that the chair of the committee that  
29           was pushing through the market design, was somehow connected  
30           with the Government? I just wanted to...

31 **PROF HOGAN:** The California Public Utilities Commission, which is  
32          appointed by the Governor, was the one who issued the initial  
33          orders and the 10 commandments and so on, and they were ignored  
34          after that, and it was a combination of things.

35           First is, as a literal matter, they don't have jurisdiction  
36           over this question any more because it's now becoming a  
37           wholesale market design issue, and that's under Federal  
38           jurisdiction as opposed to State.

39 **MS BATES:** So, they didn't actually have the political ability --

40 **PROF HOGAN:** They didn't have the legal ability to stop it.

41 **MS BATES:** Well, legal ability; there was no legislative framework  
42          which enabled them to push...

43 **PROF HOGAN:** There were some things around the edges that required  
44          their approval, but basically the design of the market and the  
45          kinds of things that were central to that were not something  
46          that they had authority to enforce.

47 **MS BATES:** Would the Federal agency have been able to do it?

48 **PROF HOGAN:** Yes, definitely.

49 **MS BATES:** And why didn't they?

50 **PROF HOGAN:** This is the point I'm trying to make here, that people  
51          describe this as a regulated system with the Regulators running  
52          the show; it simply wasn't true.

1           The attitude at the time, of the Federal Regulator at the  
2 State Governor's office in California, was that industry knows  
3 best, and so, if we have an industry process and all the  
4 stakeholders get in a room and they negotiate, why wouldn't they  
5 choose the best outcome for everybody collectively? That was  
6 the mindset.

7 **MS BATES:** I see.

8           Now, just looking at how that -- and you may have more to  
9 say, but just in broad terms, looking at how that experience  
10 might assist us to assess the proposal that's on the table --  
11 what we do have here is an Act which gives the Minister, as you  
12 probably know, the power to set objectives and outcomes for an  
13 industry EGB. In fact, the Minister has a fair degree of  
14 ability to dictate how things go under our system, I think, but  
15 I'd like to hear your view on that.

16 **PROF HOGAN:** Well, we don't have a Minister, but the Commission,  
17 the Federal Industry Regulatory Commission had the ability to  
18 set objectives and characterise outcomes that they would like,  
19 and they did, at a very high level of abstraction, but when you  
20 got down into the details about how to do it, such as the four  
21 pillars and the institutional structure, they didn't speak on  
22 this matter.

23 **MS BATES:** I suppose the design of the legislation here seems to  
24 have a fall-back position which is that if the industry EGB  
25 doesn't deliver on specified outcomes, then there will be a  
26 Crown EGB.

27           Do you think that -- was there a parallel backstop in the  
28 United States set-up?

29 **PROF HOGAN:** There's no question there was because we already had  
30 the -- it's not exactly the same -- but we already had the  
31 Regulator in place. And so the threat there was not regulation,  
32 the threat was enforcement; so we might actually live up to the  
33 responsibilities and enforce this as opposed to deferring to the  
34 industry.

35           But what I'm trying to emphasise for you is to what extent  
36 it was, the case at the time that the Regulators and the  
37 Government had a view that all they had to do was set broad  
38 objectives and the natural process of negotiation would produce  
39 a good outcome.

40 **MS BATES:** So the political will say was for the industry operating  
41 in its own best interests, would naturally operate for the good  
42 of the whole?

43 **PROF HOGAN:** That's correct.

44 **MS REBSTOCK:** But, nevertheless, it sounds like you had a Crown EGB  
45 model, but the Crown EGB model decided to adopt an approach that  
46 let the industry run the decision-making and nevertheless it was  
47 a failure of the Crown EGB model?

48 **PROF HOGAN:** I think that's a fair analogy and a fair description,  
49 and it was a failure of regulation as much as it was a failure  
50 of the industry.

51 **CHAIR:** I think where you're heading, as you know from the work  
52 you've done here, there's been no normal electricity regulation

1 from an economic perspective, notwithstanding any changes in the  
2 industry, some of which you were involved in.

3 So, to some degree, that's also an environmental issue,  
4 from a regulatory perspective, and maybe as you work through you  
5 might care to make some observations on that background as well.  
6 I just leave it on the table for a moment. I don't want to put  
7 you off your theme.

8 **PROF HOGAN:** It's certainly true there are differences. As I said,  
9 we had Regulators in place, we had legal authority in place, we  
10 had broad objectives in place, and broad guidance, but we had a  
11 hands-off view about this, and the implicit, not explicit  
12 threat, but the implicit threat was that if things didn't go  
13 well then the Regulator would jump in, and in fact that's what  
14 happened.

15 Now, I'm not sure that we've been -- and I'll describe what  
16 they are doing -- but I'm not sure it would have been so easy if  
17 we didn't have the Regulators in place because then you'd have  
18 to go through all that process of getting them up to speed and  
19 whatnot. And that, as I will emphasise, is a very difficult  
20 task because --

21 **CHAIR:** I think you say in your paper there was a regulatory  
22 structure there, effective or not is a matter of opinion  
23 obviously, but the market there, of course, was developed in the  
24 absence of a formal Regulator. There still isn't a specific  
25 Regulator on the US model in place?

26 **PROF HOGAN:** That's correct. That's a correct description in New  
27 Zealand, but, as I said earlier, my view is that ECNZ and the  
28 leadership of that enterprise provided the kind of leadership  
29 that was needed in order to design something in the public  
30 interest.

31 **MS REBSTOCK:** Professor, I just wanted to follow-up one more  
32 matter. The New York case and the California case undoubtedly  
33 have lessons, but you yourself have acknowledged that the market  
34 rules that have been put in place here -- we do have an  
35 effective market working right now, the Rules have been in place  
36 for a number of years. We are not starting from the scratch  
37 position that they were starting in in New York, and as you've  
38 indicated when the original rules were developed here they were  
39 developed with the broad public interest in mind.

40 If we authorise this proposal we are not starting from  
41 scratch, we're starting from a set of rules that were developed  
42 fundamentally with the public interest in mind, if we accept the  
43 proposition you put to us.

44 It seems to me, unless there's something about the  
45 arrangements that allow really the industry to take this back to  
46 the beginning, are not quite at risk in the same way that might  
47 have been the case in New York and possibly California.

48 So, I'd kind of like your comment on that, because while  
49 these cases in the States are interesting, we're starting from a  
50 different position here, it seems to me, and it must afford us  
51 some firmer foundation to move forward on.

1 **PROF HOGAN:** Well, what you say is true and it's extremely  
2 important. You don't want to get caught in the trap of, "We're  
3 better than California, we're okay because that's a pretty low  
4 standard." but where you are starting is with a very good  
5 design, and what I'm trying to distill from this experience is  
6 not that I expect -- I'm not trying to say that I anticipate  
7 that it will be California here in New Zealand, quite the  
8 contrary. I don't think it will be for a variety of reasons.  
9 What I'm trying to point out is that it is the evidence -- I  
10 can't find any evidence in the electricity experience anywhere  
11 where you had a true industry led process to design the Rules  
12 without a public interest decision-maker who in the end either  
13 imposes certain rules or invokes the public interest with some  
14 authority that has produced a good outcome.

15 **MS REBSTOCK:** But I guess what I'm asking you is that the right  
16 question, given the starting premise which was the basic things  
17 that have been developed here, we have an effective market  
18 working, we're not starting from that question. That isn't the  
19 right question, it's, now that we -- we accept the view that the  
20 original rules were put in place with public interests in mind,  
21 they are now embedded in the proposals that are before us.

22 Is it necessary -- all in all is it necessarily the case,  
23 looking forward, that you'd have the same difficulties that you  
24 might if you were starting from scratch?

25 **PROF HOGAN:** Well, I think that's the wrong way to think about it,  
26 and I make a distinction here between the market design rules  
27 and the decision-making rules to change the market design rules.  
28 And so you have very good rules for the market design in place  
29 and you are contemplating changing the decision-making rules or  
30 modifying them; you are contemplating a change in the governance  
31 process.

32 The governance process is built on a premise that industry  
33 will always choose a good outcome because it's in their own  
34 interests collectively, and I'm suggesting to you that there is  
35 very strong evidence that that's not the case.

36 **CHAIR:** Again, without disturbing your train of thought, the  
37 legislation which you may have looked at does enable the  
38 Government, I think, to set -- form some objectives or  
39 performance standards so to a degree there is an ability to  
40 intervene in certain circumstances. It's somewhat a lengthy  
41 process, but I think designed to see if that industry rules and  
42 application can proceed.

43 The second point, I might be jumping the gun a little,  
44 given your comments about Transpower on page 5, and, as I say,  
45 I'm not making an observation on the comments themselves, but  
46 are you in essence suggesting that a body or institution with  
47 this public interest objective has got to be some part of an  
48 ongoing electricity market, for the reasons you evidenced in  
49 California?

50 **PROF HOGAN:** Certainly the situation is different here, and you're  
51 lucky -- it's not just luck. I mean, it's a good thing for New  
52 Zealand it is different. But what I'm arguing, I guess, is

1 that -- I think the answer to the second part of your question  
 2 is "yes", that there must be some decision-making body with  
 3 authority that has a public interest mandate, objective, that  
 4 is -- and you can call it the Regulator, you can call it the  
 5 system operator, you can call it the Crown EGB, I don't know --  
 6 I mean, that's a detail which is important but it's different  
 7 and you can do it in different ways.

8 I think the character of electricity markets is complexity  
 9 of these markets, and the interconnectedness of all the little  
 10 pieces is that you can easily have the industry vote on a change  
 11 in the Rules, take congestion rentals and lost rentals and take  
 12 them out of control of Transpower and give them to somebody else  
 13 in New Zealand, which they would view as innocuous or better  
 14 for whatever the reason or another, and that is the kind of  
 15 small change that actually has great ramifications going through  
 16 the system because it would then make it impossible to introduce  
 17 the financial transmission rights. It would then make it  
 18 impossible to provide property rights that would support  
 19 merchant transmission investment. It would then make it much  
 20 more difficult to get decisions made to expand infrastructure in  
 21 transmission, it propagates through the whole system.

22 I could easily envision a vote by the industry body under  
 23 these voting rules to make such a decision and I've seen that  
 24 happen elsewhere.

25 **CHAIR:** Just again to follow it through. We haven't heard from  
 26 Transpower yet or some of the user generators. I mean, the  
 27 Conference thus far has been mainly the applicant and the  
 28 proponents of the industry EGB. One of the critical points made  
 29 yesterday was that the structure has been developed, and I  
 30 accept your point about voting rights which do become critical,  
 31 nevertheless, is designed to have a closer and more meaningful  
 32 interface between some of those major, what you described as  
 33 "stakeholders" in the US.

34 We'll obviously hear from Transpower and from users, but  
 35 the point was made by the applicant that in their view the  
 36 process, and you pick it up in your paper, will get this  
 37 critical transmission long-term objective aligned to the demands  
 38 of the users of the transmission, there would be this vexed  
 39 question of payment and liability.

40 So on the papers that would appear to be one of the  
 41 objectives of the current proposal.

42 If the institution you mentioned at page 5, be it  
 43 Transpower or Joe Smith or whoever, is in fact an effective  
 44 participant in the industry model, would that in essence pick up  
 45 some of your concerns about having this good shepherd or  
 46 guardian angel who's there to keep that public interest to the  
 47 forefront?

48 **PROF HOGAN:** Well, we had parties that were trying to argue for the  
 49 public interest in California, and PJM in the early days, and  
 50 they were ignored and couldn't control the process.

51 My own view is that for some of the decisions that are  
 52 highly contested and where there's a lot of conflicting



1 commercial interests, there is no voting mechanism that produces  
2 good outcomes. It's not a matter of tweaking it, that is  
3 slightly different; I just don't think there is. And that's  
4 where you need some decision-making body that has the public  
5 interest objective.

6 **MS BATES:** Can I take that a bit further, because when we were  
7 talking before what seemed to emerge to me was the overriding  
8 important factor is the political philosophy that determines  
9 which way the -- which way it's going to go. Do you agree with  
10 that?

11 **PROF HOGAN:** That is certainly extremely important. It's necessary  
12 to have a good institutional structure, but it's not sufficient.

13 **MS BATES:** So, on either of the models that -- either the  
14 counterfactual or the industry EGB, you could still end up in a  
15 similar position even though the Minister under the Crown EGB  
16 has a decision-making power, if the Minister takes a more  
17 laissez faire view of how the industry should run?

18 **PROF HOGAN:** I agree.

19 **MS BATES:** So how can you guard against that?

20 **PROF HOGAN:** Well you're having an election on the 27th. I mean, I  
21 think that's the way democracies work, is you change -- the only  
22 thing you have in the end to protect yourselves against bad  
23 political performance by politicians is the voting booth, and  
24 that's not a perfect system. We have this problem.

25 **MS BATES:** Okay, I'll take you back to the two examples then  
26 because that's what we're having to look at. Why do you think  
27 that one, or do you think that the Crown EGB is likely to lead  
28 to better outcomes than the industry EGB?

29 **PROF HOGAN:** I think it's more likely because I think it meets a  
30 necessary condition. It's not sufficient. So, if you don't  
31 have a well-informed and active individual or individuals that  
32 are on the members of the Crown EGB that are appointed to this  
33 position, if they don't stay on top of it, and you do have to  
34 stay on top of it because it's complicated, then they won't  
35 perform well. But if you do have talented individuals, and New  
36 Zealand has talented individuals who could do this, then they  
37 are in a position to do something to foreclose problems or to  
38 react to them quickly when they start to develop. But if  
39 they're not there...

40 **MS BATES:** Why would you not get these talented individuals being  
41 members of an industry EGB?

42 **PROF HOGAN:** As I understand the industry EGB proposal is that  
43 they're primarily process orientated, trying to make sure that  
44 the process works fairly, and they don't have the anticipation  
45 of having to make any decisions themselves about the substance  
46 of these matters.

47 **MS REBSTOCK:** If that bit was different, and if the proposal before  
48 us -- instead of having this elaborate voting structure  
49 arrangement, had in it the final decision-making power by the  
50 EGB board, would your concerns -- I understand there's still an  
51 issue about the philosophy, but if it's independent, they're  
52 selected in the manner that is proposed which is with Government

1 oversight and involvement, subject to Government Policy  
2 Statements, does it fundamentally fix most of what your concern  
3 is?

4 **PROF HOGAN:** Well, you have to see the details, but if they're an  
5 independent board -- and that depends on how they're selected  
6 and so on -- if they have the authority to make decisions; if  
7 they have a charge to act in the public interest, even though  
8 the majority of the industry may not be supporting some  
9 particular decision but they think it's important, then I think  
10 something like that is what I would call regulation by another  
11 name. So, I don't -- I wouldn't have any problem with that.

12 I mean, how you manage that process and how you organise it  
13 is important, but the critical things are those; that they're  
14 independent, that they have this public interest and that they  
15 can make decisions.

16 **CHAIR:** You see, I think just again to extrapolate it a little, the  
17 way the market's operated so far as I understand it, I'll leave  
18 the question of the definition of public interest to one side --  
19 but at least in the current structure there is an ability  
20 certainly for market disputes to be looked at dispassionately,  
21 and I think this has happened.

22 Now, there is a similar proposal in relation to a panel to  
23 work with or advise the board. Again, as the Commission  
24 understands it, the Government is proposing to set for an  
25 industry -- for what the proponents are putting up, performance  
26 standards to be reported on annually, with a fall-back position  
27 of the Government being able to either change those or on advice  
28 move towards a Crown model.

29 So, there is, in my view anyway, in the proposals an  
30 attempt to at least have some of those disciplines that are  
31 concerning you.

32 Now, we've got to make a judgment, obviously, as to how  
33 that's going to pan out. So, it's just a question really. It  
34 would appear from what you say that some of those suggestions  
35 may at least be compensating for the lack of a formal Regulator,  
36 is what I'm saying.

37 **PROF HOGAN:** I understand that that's a possible view, but I don't  
38 share it, and I think, if you look at what's happening now, the  
39 Federal Energy Regulatory Commission -- this is getting ahead of  
40 my story a little bit -- but they actually reorganised  
41 themselves a couple of times over the last several years to be  
42 much more hands-off, much more process orientated, much more  
43 aggregate criteria evaluating kind of thing, as opposed to being  
44 prescriptive and monitoring what's going on on a day-to-day  
45 process.

46 The latest reorganisation, the principal activity  
47 of which is to have new Market Surveillance and employ a lot of  
48 market economists who were supposed to be studying exactly  
49 what's happening in these markets on a day-to-day basis, and  
50 because they have come to the recognition that it is quite  
51 complicated, and it's very difficult to set a simple set of

1 performance standards that have any bite, that have any meaning  
2 to them. So they are going very much in the opposite reaction.

3 **CHAIR:** No, I appreciate your comment. When I say "it's my vies",  
4 I'm not taking a judgment on the proposal before us; what I'm  
5 saying is, I think the proponents of the proposal are looking  
6 for that way of filling some of the gaps you mentioned. But,  
7 from your point of view, David, it would be insufficient as you  
8 see it?

9 **PROF HOGAN:** Yes.

10 **MS BATES:** Can I take you back to the counterfactual being a Crown  
11 EGB. We heard from the applicant that there was a concern that  
12 the Crown EGB, having the Minister as a decision-maker, was far  
13 more likely to be susceptible to lobbying by, say, Transpower or  
14 consumer interests.

15 Do you agree with that view?

16 **PROF HOGAN:** More susceptible than the industry EGB, is that the  
17 idea?

18 **MS BATES:** Yes.

19 **PROF HOGAN:** I'm not sure. I mean, I think they're all susceptible  
20 to lobbying and that's life, you can't avoid it.

21 **MS BATES:** But there's probably, if the industry EGB doesn't have  
22 decision-making power, there's not so much point in lobbying it.

23 **PROF HOGAN:** That's a -- well, that's a different statement, that's  
24 not that they're less susceptible, they're less relevant, so you  
25 don't have to worry about them. But if there was some reason in  
26 the process, I don't know why the lobbying efforts couldn't be  
27 directed against them.

28 But lobbying will take place, and people will lobby for  
29 their interests, and if Transpower -- frankly, if Transpower  
30 with its public interest objectives is a good lobbyist, I'm not  
31 sure that's a bad thing.

32 **MS BATES:** Okay, just taking you on a step. In counterfactual we  
33 have the Minister with a decision-making power, right, and we've  
34 identified that Ministers can have different political agendas  
35 so it just really depends on the Minister, to some extent, how  
36 effective it all is.

37 What would be your view of a Crown EGB that had itself the  
38 decision-making power?

39 **PROF HOGAN:** Well, I think -- as I understand the proposal, that is  
40 effectively a Regulator, much like the Federal Energy Regulatory  
41 Commission would be in the United States, and I am of the view  
42 that in this balance between markets and regulation you have to  
43 have a Regulator who is overseeing the Rules and the  
44 institutions. They shouldn't be deciding on, should you invest  
45 in this generator or that load management programme, that's a  
46 different matter, markets can take care of that, but in deciding  
47 on the pricing rules and the nature of the institutions like the  
48 spot market and that sort of thing, that that's their  
49 responsibilities.

50 **MS BATES:** Thank you.

51 **CHAIR:** Perhaps continuing with that, perhaps side-tracking you a  
52 little bit --

1 **PROF HOGAN:** No, they're all very much on point.

2 **CHAIR:** Your comments are certainly appreciated.

3 **PROF HOGAN:** Let me leave the California story other than to say  
4 that, mostly so that I can go home, in January of this year, as  
5 I said, they suspended activity on their reform efforts and they  
6 have been dealing with chaos ever since then. But in January of  
7 this year, partly at prompting from the Federal Regulators, the  
8 California independent system operator resumed this effort of  
9 market redesign and market reform, and there is a very  
10 argumentative effort underway now.

11 What's important about it is that they have completely and  
12 explicitly rejected all of the assumptions and philosophical  
13 constraints of the four pillars in the earlier design. This  
14 appeared in a document in January. The minute I read it I did  
15 the same thing I did when I saw the MoU in 1995, which is I  
16 wrote a paper about it and circulated it everywhere, which is  
17 described as "a breakthrough in California", to recognise they  
18 had done a good thing and this is going in the right direction.  
19 There's a lot more going on in that right now as we go through  
20 so the California system now, as a literal matter, is trying to  
21 look something which is very much like the New Zealand design.

22 Maybe in the interests of time, although I'm happy to go  
23 through it in detail, let me summarise the New England  
24 experience quickly --

25 **MR CURTIN:** I'm dreadfully sorry to do this, and we will let you go  
26 back to the States, but just very quickly on California; we  
27 heard two ideas. You mentioned in the coalition of stakeholders  
28 that it did include the fairly powerful Consumer Act or  
29 representation. I suppose it's kind of surprising that maybe  
30 they didn't seem to have had an effective look at the process, I  
31 mean, whatever -- an industry looking after its own interests.  
32 Was there anything that prevented the consumer organisation from  
33 getting fair representation in the Californian design?

34 **PROF HOGAN:** It's always a problem that consumer groups are not  
35 well represented in sort of the total weight and the number of  
36 people because it's very dispersed and so on. But they did have  
37 these two organisations and the principal player there was a  
38 fellow named Mike Florio, and he's very good, and I have great  
39 respect for him. He is an example of the problem that I talked  
40 about before, which is why I thought that they didn't know what  
41 they were doing to themselves, that they didn't understand how  
42 complex this was and that they were agreeing to compromises that  
43 they thought didn't matter very much, and he was mistaken, and  
44 he regrets it. He's been involved in this process all the way  
45 through, and when we organised the reform coalition in the  
46 beginning of 2000 that I mentioned, he was a prominent member of  
47 that group.

48 And now he's very much the -- I mean, he doesn't say the  
49 words "New Zealand", but he says, "New Zealand got it right and  
50 we got it wrong" in essence because he's saying the design we  
51 should be following -- it's typically noted in the United States  
52 as PJM, but that's very similar to what is done here.

1 **MR CURTIN:** Sorry to distract you.

2 **CHAIR:** Sorry to distract you again, I'm sorry.

3 Your last comment about the NZ design as being not all that  
4 bad or perhaps got it right. Perhaps if you go to the New  
5 England one, where some of those details might be relevant to  
6 what's in front of us, it might be appropriate if you could  
7 cover them. I would be interested too, if you think the New  
8 Zealand one is going wrong, because it's critical to what we're  
9 looking at, in your view, given that you have commented that  
10 some parts of it have been right.

11 **PROF HOGAN:** Again, I'm making the distinction between the market  
12 rules and the rules for changing the Rules. I think your market  
13 rules are very good. I've always been worried about your  
14 governance process, and that's what this EGB proposal -- we're  
15 not -- I don't dispute in the proposal about the market design  
16 at the moment, with the exception of the need for financial  
17 transmission rights.

18 **CHAIR:** That's being worked on as we understand it.

19 **PROF HOGAN:** What I'm worried about is the process going forward to  
20 make changes in the Rules.

21 In order to save a little time, let me just say --

22 **CHAIR:** We have a bit more time if you want.

23 **PROF HOGAN:** I think New England, because of the discussion before,  
24 Ms Rebstock's problem about what was the actual problem in  
25 California with the new generation hook-up policy, I can say  
26 that the same problem developed in New England, slightly  
27 different in its character but essentially the same problem.  
28 They had a single zone for the pricing rules that were set up.  
29 There was a stakeholder process in New England that put together  
30 a design that was around 96 and 97, I was not involved in that  
31 process, but they voted on a market design that was not as bad  
32 as California's, say, but had some of the bad features; one of  
33 them was this, they didn't use locational pricing. What  
34 happened was new generators wanted to locate in places where it  
35 was cheap. They couldn't take them because the transmission  
36 grid wouldn't accommodate it. They adopted a rule that the  
37 transmission -- the new generator would have to make the  
38 investment to upgrade the transmission grid in order to make  
39 sure that they wouldn't compete with the existing generators.

40 **CHAIR:** That cost fell on the new generator?

41 **PROF HOGAN:** Right, exactly. And this went forward to the Federal  
42 Regulators. Curiously enough, this was before the California  
43 experience with the same event, but California is a long way  
44 from Massachusetts, so they don't read each other's findings I  
45 don't think. New England went to the Federal Regulators with  
46 this amendment, they came back and said, "No, this is a barrier  
47 to entry", exactly the same thing they later said for  
48 California. The problem of it comes from your congestion  
49 management system, you have to go back and rethink this market  
50 design with the congested management and so on.

1           That was actually the first one of the events where the  
2 Federal Regulators started to assert themselves on the substance  
3 of these market designs.

4           When that happened I helped to organise another coalition  
5 which consisted of the conservation law foundation, which is a  
6 principal environmental group in New England, New England  
7 Electric, which is a large utility and new independent power  
8 producer, again to get this spectrum, and that gave us  
9 understanding in the stakeholder process and so we went to  
10 discuss these matters.

11           The message here is about structured voting rules and  
12 decision processes. So, there are two organisations in  
13 New England, there's actually NEpool, which is the descendent of  
14 the New England power pool, which is like an industry EGB with  
15 structured voting rules in a sense. They're the ones who are  
16 supposed to decide on the market rules and things like that, and  
17 then they created an independent system operator with an  
18 independent board, but they're just supposed to follow the  
19 Rules, so they're not supposed to necessarily change them.

20           The process was under NEpool that we were involved in and  
21 we had a lengthy discussion which lasted about a month, I think,  
22 the first one, with intense Working Groups every day going  
23 through this process, and we were proposing a market design not  
24 surprisingly like PJM or New Zealand, this group. There was a  
25 vote that was taken at the end of that month about what market  
26 design should they adopt, in particular should they adopt the  
27 market design that we had.

28           As I recall, the vote at the time was 66 to two against.  
29 We had two votes, the Conservational Law Foundation didn't have  
30 a vote but they were there as a public interest group, and they  
31 have a lot of political clout in New England, but didn't have a  
32 formal vote. There was virtually unanimous opposition to the  
33 proposal that we were making, and the attitude there was  
34 basically anything but PJM so they take any market design but  
35 the one that I think works. It's partly a "not invented here"  
36 syndrome.

37           But they had a problem on their hands and the pressure was  
38 coming from the Federal Regulators that they had to do something  
39 about this because they just couldn't let this sit. What  
40 happened was we had -- the stakeholder process went on and on  
41 and on and on. Eventually, through sheer exhaustion, trying  
42 everything else that they could think of other than the PJM  
43 model, they came to the conclusion that that was the only thing  
44 that worked and collectively as a group, and if we could have  
45 isolated a vote on that market design alone, we would have been  
46 able to get a decision in favour of doing it. Unfortunately  
47 there were a lot of other things that came up in the process,  
48 because everything's connected to everything else, and so there  
49 were other issues about installed capacity markets and certain  
50 contract arrangements, and different parties had different  
51 commercial interests in respect to those things. When the  
52 package came for a vote for the proposed rule we could not get

1 the two-thirds majority needed to pass the change, we came  
2 slightly short of a two-thirds majority.

3 Then something happened, which was important for your  
4 interest, which is the independent system operator has an  
5 independent board and in the failure of this stakeholder process  
6 to produce an answer, the independent system operator went to  
7 the Federal Regulators and asserted for the first time its  
8 independence and said, "We have to do something, time is running  
9 out", and they offered the proposal that had gotten a little bit  
10 less than two-thirds majority which could not get through the  
11 formal voting process.

12 The Federal Regulators, of course, were delighted to have  
13 this because they now viewed this as the right answer and so  
14 they instructed them to adopt it in New England, and they're now  
15 in the process of trying to implement that with next year being  
16 the deadline, they acquired software from PJM and the like.

17 So, it was an interesting case because they had many of the  
18 features of this process you're talking about here, an industry  
19 process, they had structured voting, they had a good idea, but  
20 they couldn't get the good idea through because of the competing  
21 interests of the parties, but they had the benefit of a  
22 Regulator that was putting the pressure on them and they had an  
23 independent board that could make a decision which was to go  
24 forward and offer this alternative that the parties wouldn't  
25 support according to the necessary super majority.

26 **MS REBSTOCK:** Can I just ask a question. You talked a lot earlier  
27 about how complex these issues are and that you have to be  
28 fairly close to the operational level to understand them, that  
29 the good guys in all these stories are Federal Regulators who  
30 presumably are far removed, and I have a little difficulty  
31 understanding how that body, being far removed from each of  
32 those State Regulators, knows enough about those different  
33 operating systems to be able to play that sort of referee role.

34 We've heard a lot about the difficulties of that and the  
35 downfalls of it, so I'd be interested in your comments.

36 **PROF HOGAN:** It is difficult, and I'm -- if I'm being critical of  
37 the performance during this timeframe by the Regulators, which  
38 is a problem, of course, I recognise -- and I've always  
39 recognised that in discussions with them, that this is a very  
40 hard problem and they get a lot of competing advice and it's  
41 hard to figure out the answer, they were trying initially to  
42 avoid having to get into the detail.

43 They have been overwhelmed by experience so they just  
44 haven't been able to avoid it, and they are now -- it's  
45 developed -- the institutional knowledge has developed in the  
46 staff and in Members of the Commission that have been there for  
47 a while, and some of them came from the States, such as the  
48 chair and Nora Brownell from Pennsylvania, for example, a State  
49 Regulator, they now have come to know a lot more about  
50 electricity systems than they ever wanted to know, and they  
51 recognised that this is actually a problem and that you can't  
52 have 1,000 flowers bloom and expect them to grow compatibly,

1 that you need to have standard principles that are standard  
2 design that are efficient and pro-competitive.

3 What's happened, starting basically last year and  
4 accelerating under the leadership of Pat Wood, who came from  
5 Texas, is a very proactive regulatory body that has responded to  
6 the crises that we have; and we have a very serious problem in  
7 the United States particularly because of California and all the  
8 things related to it, which is that we are sort of half-way in  
9 between, we have good institutions in some places, like PJM but  
10 not others, and it's very dangerous and could fail badly on  
11 their watch, and they don't want it to fail so they have taken a  
12 view -- the Regulator has taken a view that they have got to  
13 solve this problem relatively quickly.

14 So they have launched an aggressive effort to create these  
15 new organisations, which is essentially the independent system  
16 operators, they call it regional transmission organisations.  
17 They have started that process formally, which they began  
18 discussing last summer, but it's formally underway, called the  
19 Standard Market Design Rule Making, which could be out -- the  
20 next stage of that could be out in the next few days or  
21 something like that, and the staff papers that describe it get  
22 into great detail about things like how FDR markets work and how  
23 auctions work, and how locational pricing works and so on; they  
24 don't get down into the software level of detail, but get down  
25 into the design level, which is much more than broad principles  
26 about promoting competition or something like that. They are  
27 pushing very hard in this and I think it's important that they  
28 do and I support their efforts, but it's a dramatic change from  
29 where we were in the mid-90s.

30 Yesterday I understand that Chairman Wood -- I was reading  
31 the press before I came over this morning -- was quoted as  
32 saying he was looking more and more skeptical about the ability  
33 of the industry to respond "voluntarily" in joining these  
34 regional transmission organisations. Now, this is "voluntary"  
35 with pretty strong incentives, but they're just taking too long  
36 and there's too much delay, there's too much positioning in one  
37 versus another that's making it hard, and he was saying quite  
38 explicitly that he's thinking time is running out and he may  
39 have to just dictate, make it mandatory what they are going to  
40 do.

41 The Supreme Court is helping them, because there was a very  
42 important Supreme Court decision a few months ago which  
43 reinforced the authority of the Regulator to do this, and so,  
44 it's a ground swell of change in the approach to this problem  
45 from deferring to industry processes and industry design on the  
46 Rules, to have the Regulators take a very proactive role in  
47 setting up the Rules so that the market can then operate  
48 underneath that set of Rules.

49 **MR CURTIN:** Just to take you back to that original 66:2 vote, I  
50 appreciate you were trying to summarise very quickly and you  
51 mentioned there was not an invented here factor running, but I  
52 have to say there were more substantial issues of concern to the



1 commercial interests voting against the market design, perhaps  
2 because they lost market power and a competitive clearing  
3 market, I don't know, and there were winners and losers, who  
4 knows. Would you care to give us a flavour of what commercial  
5 interests were at stake and why they were so uniformly against a  
6 clearing market design?

7 **PROF HOGAN:** Well, I go back to my description of the problem in  
8 California with the three different views. Certainly some of  
9 the commercial interests -- there was one, Florida Power and  
10 Light that had bought a lot of power plants in the northern part  
11 of New England which, if it went to a locational pricing system  
12 as against a common price across the whole region, they were  
13 going to lose hundreds of millions in asset value, if you  
14 recognise the real contribution they were making to the system  
15 as opposed to official contribution. Needless to say, the  
16 people responsible for those purchase decisions no longer work  
17 for Florida Power and Light because they did lose hundreds of  
18 millions of dollars when the Rules were changed. So, there was  
19 a very clear commercial interest on their part.

20 But I think the more dominant problem is this one I talked  
21 about before, which is, people don't -- it really does take a  
22 lot of work to understand this and they just wanted to think  
23 that it was simple, and the New Zealand model looks complicated,  
24 and we want something that's real simple; can't we have two  
25 zones instead of one or can't we have a simple rule for  
26 upgrading the grid or something like that; or couldn't we have a  
27 National Grid come in from England and solve all our problems  
28 for us? It's the "go home early" strategy, without doing the  
29 hard work to figure it out.

30 To their credit, when they were forced to stay in the room,  
31 because basically the Regulator wouldn't let them leave and  
32 wouldn't let them produce something that was anti-competitive,  
33 so there was somebody who could say, "No, you're not going to do  
34 it that way", then they got down and they did the hard work, and  
35 it was exhausting, but eventually they came around to a  
36 completely different view and now they're quite supportive of  
37 this different view.

38 So, I don't think there's a simple answer to that. There's  
39 partly competing commercial interest, partly because people  
40 don't understand it, partly ideology because if you are in  
41 favour of co-ordinated spot markets you must be a Communist.  
42 I'm not making this up, I get called this all the time.

43 **CHAIR:** I think I have some empathy for your last comment  
44 occasionally, but we probably have about an hour -- I mean,  
45 12.30 was the scheduled time. If we go to 1.00 -- what I'm  
46 really asking is, are there some more points in principle you'd  
47 like to cover so we have time to come back and question you, so  
48 that we make the best use of your experience and enable us to  
49 pick it up and extrapolate on it, because I think -- I'm  
50 certainly finding this a very interesting presentation, what's  
51 coming out of it. We can go to 1.00 if you are willing.

52 **PROF HOGAN:** Yes, that's fine.

1           The other two subjects that I mentioned at the beginning I  
2 wanted to make some comments about are the use of industry  
3 information in the decision process, and then infrastructure  
4 investment. So, let me say something about each of those  
5 briefly, and I think it actually responds to some questions you  
6 asked previously.

7           What I'll try to do is try to describe the PJM decision  
8 process, which is not unique but is an example of one that seems  
9 to be working rather well. It wasn't a decision process that  
10 produced the initial PJM design, and that went through a mess,  
11 and I figured two messes was enough, you know, New England and  
12 California was enough, but they had their own problems in PJM,  
13 but they fixed it later.

14           The process since about 1998: They have an independent  
15 board for the independent system operator and that independent  
16 board is regulated -- the PJM was regulated ultimately by FERC,  
17 so they have to answer to them informally, and then any changes  
18 to the Rules have to be approved by FERC and so on, but the  
19 board itself can make decisions about what should be done.

20           The State Regulators have no formal authority over PJM, but  
21 have a lot of informal influence with what happens there so that  
22 there is a certain amount of discussion that goes on with them.

23           Then inside they have an industry group, they call it the  
24 Member's Committee; it's a stakeholder process with structured  
25 voting and all the other kinds of things, and Working Groups  
26 underneath those, and they meet all the time. They're about one  
27 thing or another about changing the Rules, the timing of things,  
28 implementing new features of the market design and so forth, and  
29 that comes through the Member's Committee and the Member's  
30 Committee votes on rule changes and those votes are advisory to  
31 the board. The board is not constrained to either implement  
32 recommendations that they make or fail to -- or to not offer  
33 things that they fail to recommend; the board can act  
34 independently.

35           As a practical matter, I have to say that -- I'm not sure  
36 there's been any decision yet that in the end hasn't been  
37 supported by the board, but because they have this independent  
38 authority it has an enormous impact on the way the conversation  
39 goes.

40 **MS BATES:** Can I just ask you, who appoints the independent board?

41 **PROF HOGAN:** They do, so the Federal Regulators set up a -- the  
42 stakeholder designed it but the Federal Regulators approved the  
43 start and what they did is they hired an executive search firm,  
44 the executive search firm had certain criteria that they had to  
45 meet --

46 **MS BATES:** Sorry, who is "they" in this context?

47 **PROF HOGAN:** The Federal Regulator approved the process, the  
48 stakeholder proposed it to them. They hired.

49 **MS BATES:** The stakeholders hired them?

50 **PROF HOGAN:** There always was the PJM system operator, so they  
51 signed the contract, it was like Transpower signing the  
52 contract, so they were directed. They hired an executive search

1 firm, and there was a list of criteria and whatnot, and they  
2 produced a slate of members for the board, and the Member's  
3 Committee voted to ratify the slate and they ratified the slate.

4 Now, this established the initial board. They have -- the  
5 board itself has a two year rotating -- every year, I think, two  
6 members come off or something like that; so it's staggered is  
7 the point. The replacements are nominated by the board, so it's  
8 a self-replicating board. But when the replacements are  
9 nominated, it's voted on by the Member's Committee, and then the  
10 Member's Committee can either ratify the slate of two or not.

11 **MS BATES:** What happens if it doesn't?

12 **PROF HOGAN:** I don't follow this closely, but my understanding is  
13 that this has only happened once and only for a few hours. The  
14 Member's Committee doesn't like this process apparently, and I  
15 don't know what their alternative is, but recently they had two  
16 vacancies come up, two nominations were made, and they were  
17 voted down by the Member's Committee; then there was a lot of  
18 conversation over the day and at the end of the day they were  
19 ratified. So, they were sending a signal. So I would say that  
20 this is a work in progress about how this is going to evolve,  
21 but that's where it is at the moment.

22 **MS BATES:** Thank you, that's interesting.

23 **PROF HOGAN:** So they have this independent board and FERC approval  
24 at the other end.

25 Now, the Working Group process and the stakeholder process,  
26 when they're talking about rule changes, it's very extensive;  
27 it's administered by the independent system operator staff and  
28 the general sense of this, that you get from industry  
29 participants, is that they do a very good job.

30 Now, there's no guarantee they're going to do a good job,  
31 but empirically I'm reporting that that's what has happened, and  
32 the industry has the sense that the participants think that  
33 they're being heard and their ideas are incorporated in the  
34 proposals and so forth.

35 Part of what they do is, they set up priorities about  
36 changes, so they have a whole list of things that they want to  
37 fix in the market to make it better, and then they prioritise  
38 through this Working Group process which ones to do next, and  
39 then they do them one at a time and it's a very incremental,  
40 unintentionally so, process. One of them, for example, is to do  
41 something you have been doing for a long time which is to charge  
42 for marginal losses in their locational prices which they  
43 initially didn't do. It's not as important in PJM as it is here  
44 but it is an example.

45 It's a process which, I think, works pretty well.

46 **CHAIR:** I just have to interrupt your train of thought.  
47 Unfortunately, in saying we'll go to 1 without a break, I've  
48 forgot that we have a transcriber who's working pretty hard to  
49 follow what we're saying, so if we're going past 1, we might  
50 break for 10 minutes and carry on till 1. So, if we keep that  
51 in mind, we need to give the transcriber time to catch her  
52 breath again.

1 **PROF HOGAN:** I'll leave it to you to keep track of that time when  
2 you want to break.

3 **CHAIR:** You can cover the ground knowing the need to do that.

4 **PROF HOGAN:** It comes up to this question about the incentives the  
5 industry has to provide information and the quality of  
6 information that's provided to the Board and to the Regulator in  
7 this process.

8 There is substantial literature in regulated industries  
9 about information asymmetry, and the company's know more than  
10 the Regulator, and they use that information strategically in  
11 order to improve their position relative to the Regulator, and  
12 it's hard for the Regulator to find out exactly what's going on.  
13 I think that's a pretty common argument and common view, that  
14 that's a problem with regulation, and I agree with it; I think  
15 it's a problem with regulation.

16 That history and the literature is dealing with a different  
17 issue. It's dealing with the circumstance where the Regulator  
18 is making decisions about a particular company setting its  
19 rates, setting its costs allocation, setting its rate of return.  
20 There might be some spill over to decisions that affect other  
21 companies, but it's mostly focused -- very much targeted at  
22 these rate cases that they go through in state regulation on  
23 that company one at a time.

24 The process we have here in PJM is quite different to that.  
25 It's not setting prices for particular companies, it's not  
26 setting the cost of capital for a particular company or  
27 something like that, it's setting the Rules for the market, and  
28 the Rules affect everybody, and people have different and  
29 conflicting interests, there's no doubt about that, different  
30 commercial interests, but it's been my observation, and I think  
31 the experience generally, that in this process there's always  
32 somebody who wants to get the story out, because they have a  
33 different view than the other one.

34 Now, this produces an information flow which, the problem  
35 is not that they get too little information, the Regulators get  
36 maybe too much, so there's a huge volume of filings and  
37 documents and reports and so forth that add to the burden -- the  
38 cost of regulation, no doubt, but -- and it creates a work  
39 challenge for the Regulators to have to sift through this stuff  
40 to understand what's going on. But generally speaking the story  
41 comes out; essentially, it's the marketplace of ideas in some  
42 sense where you have competing interests and people have  
43 different views about what to do, but there's quite a bit of  
44 information that actually comes out of that process. I don't  
45 claim it's perfect, I certainly don't claim it's cheap.

46 **MS BATES:** Are there provisions to enable each company to keep  
47 confidential information confidential?

48 **PROF HOGAN:** Yes, there are, and there's a lot of filing -- there  
49 are many filings that are done with the Regulators that have  
50 confidential information that are supposed to be held  
51 confidentially. Most of the decisions that have to be made  
52 about market design and market institutions are decisions which

1 don't require confidential information. The place where  
2 confidential information comes up is in market mitigation,  
3 market power mitigation in getting into individual contracts and  
4 that sort of thing, and that's a different matter, and that's  
5 evolving as we speak in the United States.

6 But in terms of the wholesale market designs and most of  
7 the Rules --

8 **MS BATES:** So the problem with confidentiality hasn't made them  
9 shy?

10 **PROF HOGAN:** No.

11 So, I think that's an important distinction. If you asked,  
12 would the industry be reluctant to speak if they were being  
13 regulated by somebody who had the authority to make a decision,  
14 and where you're talking about the old kind of regulation about  
15 their prices and their profits, well, sure they would use their  
16 information strategically. But when you're talking about  
17 changing the market design rules, the process we have here, you  
18 get a marketplace of ideas, and there's a lot of information  
19 that comes out, and the problem is sifting the wheat from the  
20 chaff in that process.

21 So, I think industry information can be made available to a  
22 Regulator, and that's certainly the experience we have in the  
23 United States and, having the  
24 Regulator there in some sense gives people the incentive to give  
25 good information about. It's not perfect, but the marketplace  
26 of ideas is evident in this process.

27 **MS REBSTOCK:** I don't understand the point that, even in designing  
28 the Rules you're not affecting the profit of the companies.  
29 Surely, they must?

30 **PROF HOGAN:** It affects the profits of the companies, there's no  
31 question about that, but it affects them in different ways.

32 **MS REBSTOCK:** Sure.

33 **PROF HOGAN:** And some of them are winners and some of them are  
34 losers, and the winners are very eager to have you understand  
35 why this is a good idea.

36 **MS REBSTOCK:** From the perspective of their place in the industry,  
37 but they may not have the information to tell you.

38 **PROF HOGAN:** That's right.

39 **MS REBSTOCK:** For instance, say they were a retailer and they had  
40 the incentive to tell you -- doesn't mean that he understands  
41 the generator's business well enough to put the counter points  
42 as to what the generator is saying.

43 So, I'm not sure that you don't still have some sort of  
44 informational asymmetry at play that raises the cost of  
45 regulation.

46 **PROF HOGAN:** There's still -- I'm not saying that the asymmetry  
47 goes away completely, or that it's perfect. What I'm saying is  
48 that the information that people are prepared to reveal to an  
49 industry EGB, I don't think there's much difference in this  
50 regard, and if there is -- I think the incentives are probably  
51 greater to reveal the information under the regulatory model

1 because they can do something with it, and that's been my  
2 observation.

3 I mean, the New York case is a perfectly good example where  
4 the Utilities took the view that what was good for the public  
5 interest was good for them, so they were extremely aggressive  
6 about explaining why what they were doing made sense and how it  
7 fitted in, and exposing the arguments of others that didn't make  
8 sense and so on, and that was very helpful.

9 **MS REBSTOCK:** But, if they take that view, they'd take it with an  
10 industry EGB as well.

11 **PROF HOGAN:** I think so.

12 **MS REBSTOCK:** So, what's the difference?

13 **PROF HOGAN:** I don't think there is one in that regard.

14 **MS REBSTOCK:** In that sense, but there is still potentially an  
15 information asymmetry.

16 **PROF HOGAN:** I don't think regulation makes the asymmetry worse;  
17 I'm saying the regulation if anything helps, but it doesn't  
18 solve the problem; there's still going to be situations you  
19 can't find out because they know and they won't tell you, and I  
20 don't have a solution for those problems.

21 **MR CURTIN:** For this argument to hold and the information to come  
22 forward, I think you're assuming that an industry EGB board  
23 would have the kind of decision-making authority that PJM would  
24 have, otherwise there wouldn't be the same point in exposing all  
25 the arguments and witness of other people's arguments.

26 **PROF HOGAN:** In that case that would argue that the regulation is  
27 better because there's more exposure, because there's more  
28 incentive, right.

29 I think, when you get into these debates that go on, the  
30 incentive to reveal information -- there will be somebody there  
31 who's prepared to reveal it. But, as we saw in California, or  
32 in New England, that's not guaranteeing that you're going to get  
33 a good outcome because, even though the information is out  
34 there -- I mean, San Diego -- I was working with them to be  
35 sure, so I don't have a completely unbiased view of this -- but  
36 San Diego was working extremely hard to get the story out, and  
37 that's another tale about what happened. They were filing  
38 documents constantly every place they could and bringing people  
39 like me and others in to make the arguments and that sort of  
40 thing.

41 **CHAIR:** But, just to be clear, you're saying that either under a  
42 regulated model or an industry governed model, provided the  
43 incentives are right, the information will come forward; but on  
44 balance the regulated approach would have a more consistent or  
45 wider information --

46 **PROF HOGAN:** Under the regulated approach you'd have good  
47 incentives for enough people to get good ideas into the process  
48 for designing the market rules. That's not the same thing as  
49 saying that, under a regulated approach of the old vertically  
50 integrated company where you're regulating them one at a time,  
51 that that didn't create disincentives; I think it did. I'm  
52 trying to make the distinction.

1 **CHAIR:** You are talking in the context of a market rule  
2 development?

3 **PROF HOGAN:** Yes.

4 The last point I wanted to speak to was infrastructure  
5 investment, and there is some related problems but I would focus  
6 on transmission investment. Let me describe what I spend a lot  
7 of my time doing in the United States.

8 The dominant view in the United States is that transmission  
9 is hard to build, that there's tremendous opposition to it and,  
10 because of its character, there's a lot of free-riding so that  
11 everybody wants somebody else to pay for expanding the  
12 transmission but not them, or they don't want it in their  
13 backyard, they want it some place else, and that it actually  
14 prevents transmission from being built or built in a way that is  
15 efficient.

16 The prominent view is that contestable merchant  
17 transmission investments of the type talked about here is, at  
18 best, trivial. I'm using a word that was used recently to  
19 describe this by someone who -- we were having a discussion  
20 about this. So, there won't be very much of it, and the only  
21 way you're going to get enough transmission built -- and we're  
22 worried about this in the United States, that we don't have  
23 enough and it's not being built -- the only way you're going to  
24 do it is step it up with a very strong public interest  
25 motivation to have regulated entities make the investments and  
26 have Regulators require people to pay for it and, if we don't do  
27 that, we're at not gonna get it built. That view is so dominant  
28 that it's almost taken for granted that that's the correct way  
29 to think about the problem.

30 So I find myself in the United States mostly outside the  
31 mainstream on this, because I've been arguing for a long time  
32 that merchant transmission investment can play a very important  
33 role; we don't know how large, but important.

34 **CHAIR:** Can you just define that merchant transmission investment?

35 **PROF HOGAN:** I'll give you an example. Trans Energy, which has  
36 also done this in Australia, is as we speak building a cable  
37 that goes from Connecticut across the Long Island Sound to Long  
38 Island. It's a DC cable, and they're taking the economic risk  
39 entirely by themselves; there's no regulation, there's no  
40 pricing guarantees, nothing. They can buy power in Connecticut  
41 and sell it in Long Island, or buy power in Long Island and sell  
42 it in Connecticut. Good luck. So, that's what I mean by  
43 merchant transmission investment.

44 There are other examples of that as well, but the critical  
45 feature is spending your own money, not having regulatory  
46 authority to force people to pay for it, and just taking your  
47 chances in the marketplace.

48 **MS BATES:** In that particular example, did that happen because  
49 demand wasn't being met by what was existing?

50 **PROF HOGAN:** It happened because the price in Long Island tends to  
51 be high and the price in Connecticut tends to be lower.

1 **MR CURTIN:** We've talked a lot about free-riding over the last  
2 couple of days and the difficulty of getting common decisions in  
3 those circumstances, but what's to prevent any transmission  
4 operator just operating a tolling system. So, you know, no  
5 toll, no transmission; where's the problem?

6 **PROF HOGAN:** The problem becomes -- the place where that's most  
7 possible is an example like this DC line because it's  
8 controllable, and so, you can actually physically control the  
9 amount of power that flows over that line, which is one of the  
10 reasons they're building it that way.

11 There are a lot of investments in the transmission systems  
12 which are not controllable in this way. You can't stop the  
13 power from going over the lines, and in some of the cheapest  
14 upgrades of the transmission system they are doing things like  
15 installing capacitors, for example, that create reactive power,  
16 and there is no flow over your line that you can charge somebody  
17 for; it's a very different kind of constraint and a different  
18 kind of problem.

19 So, it's actually quite difficult -- and this goes to the  
20 core of why transmission is complicated -- it's actually quite  
21 difficult to decide on who is actually using this facility, and  
22 that's the problem with free-riding then, is that, you can't  
23 tell whether I'm using it or somebody else is because all the  
24 power flows everywhere, and it goes on every parallel path.

25 So it's very difficult to implement the mechanism to do  
26 what you suggest, and it's impossible with AC lines capacitors  
27 and some of the most important investments that you can make.  
28 And it's an example of why this is complicated.

29 So, I find myself outside the mainstream because I've been  
30 arguing that there are ways to do this, and it has to do with  
31 using these financial transmission rights to substitute for what  
32 you are proposing. So, we don't toll for how much you're using  
33 the grid but we do create additional financial transmission  
34 rates because of the incremental capacity that your line  
35 provides, and how it's defined is -- there's a lot of detail to  
36 that, but it's a system which creates a property right and then  
37 people can get the property right as the benefit of their  
38 investment.

39 As long as you don't have very large economies of scale, so  
40 it's not a really big investment in transmission that's going to  
41 make a major change in prices -- it's small in the sense that it  
42 increases capacity but not enough to dramatically change the  
43 north/south price differential, for example -- then those  
44 financial transmission rates can serve as a property right that  
45 provides an incentive for people to make those investments  
46 rights.

47 **MS BATES:** Do you see this as being any more than at the margins of  
48 main transition?

49 **PROF HOGAN:** That's the debate which is going on in the  
50 United States and my position is, we don't know. That it could  
51 be at the margins and it could be trivial, it could be most  
52 everything. I have never argued that it's everything, and



1 that's the next point that I would get to, but it is a debate  
2 that's underway in the United States. And given what I'm about  
3 to say, I just want to emphasise that I spend most of my time  
4 arguing that merchant transmission is going to be important  
5 enough that we should make sure that the design accommodates it  
6 and the Rules are there.

7 On the other side, I think that interest is no doubt that  
8 you can construct examples, and I've worked on transmission  
9 investments back in the 80s where we actually got started on  
10 these problems; can you construct examples where free-riding is  
11 a problem where the investment has a big impact and it makes a  
12 major change in market pricing and so on? Then everybody gets  
13 into the mode of, well, they should do it or they shouldn't do  
14 it; or somebody else should do it but we shouldn't do it; and  
15 then when it's done everybody benefits and you can't put  
16 together a coalition to do that.

17 And so I've been quite consistent in arguing that you need  
18 a backstop approach, which is a regulated approach, where some  
19 entity with the authority to do it has, under certain  
20 conditions -- and I'll summarise the conditions -- the  
21 opportunity to make a decision to do what we do now for all  
22 transmission, which is to build it and then make people pay for  
23 it through regulation, and assign the benefits that are  
24 associated with that as well through the FDRs. So that you need  
25 a mixture of merchant investment where you don't have regulation  
26 involved and no guarantees and no compulsion and some  
27 investments where in the public interest you do make those  
28 investments -- these regulated investments.

29 I just think that it is contrary to our experience so far,  
30 and certainly contrary to the common view in the United States,  
31 that these regulated investments are either unnecessary or  
32 unlikely to play an important role.

33 **MS BATES:** Just let me ask you this: Why would it be necessary for  
34 the Regulator to do that if these investments were going to be  
35 profitable? Why would you not get private people wanting to do  
36 it? Why would you have to get Regulators to do it?

37 **PROF HOGAN:** The problem would be essentially that -- because you  
38 can't control the power flow, so if you can build a transmission  
39 line from Western Pennsylvania to New Jersey, everybody --  
40 prices go down in New Jersey and it's going to be much cheaper -  
41 - everybody in New Jersey will benefit from those lower prices.  
42 Everybody in New Jersey would rather that the people in Southern  
43 New Jersey should build this power line, and conversely the  
44 people in Southern New Jersey think that it should be done by  
45 the people in Northern New Jersey, and this debate goes on for  
46 years. Actually, I was involved in such a situation with a line  
47 going across Pennsylvania to New Jersey; you just couldn't get  
48 the coalition together to get agreement on what to do, and that  
49 is the free-riding problem.

50 If it's narrow enough so that you can capture the benefits  
51 so you build a line to Southern New Jersey and the benefits are  
52 only in Southern New Jersey, then that's a different situation.

1 But there are circumstances, and people always give you these  
 2 examples of, well, if you built a really big line, Auckland, and  
 3 we reinforced it then the price differential in the North Island  
 4 would go away. But nobody wants to pay for it because they want  
 5 somebody else to pay for it, and then this price differential  
 6 goes away and then you're in this infinite loop where nothing  
 7 actually gets done. And I think that could happen, and the  
 8 dominant view in the United States is, that's only what happens.

9 I don't think that's -- that's not my view, but I don't  
 10 argue, as some might, that you don't have to worry about this  
 11 problem; I think you do have to worry about this problem.

12 Then the question is, the voting rule -- which is this 75%  
 13 majority for putting together a coalition to make the other 25%  
 14 pay -- is not going to be likely to produce these kinds of  
 15 investments, and my sense of it is from the kinds of things I've  
 16 been talking about -- we couldn't get a two-thirds majority in  
 17 New England for a set of rules which made sense -- is that, it's  
 18 just too easy to obfuscate this, it's just that 26% can defeat  
 19 it; that the kind of situations where you really do have a big  
 20 free-riding problem, it would be very difficult to get the vote  
 21 to go ahead and do it in the way that is envisioned. So, in  
 22 that sense, the threshold is too high.

23 On the other hand, my guess is that this mechanism would be  
 24 used a lot. Because, if you think about it, suppose there's two  
 25 of us that want to build a transmission line that's going to  
 26 benefit the two of us, and these things are usually complicated  
 27 so we can start this process and say that there's 24% of the  
 28 other -- of the cost of this produces benefits for other people,  
 29 you, you and you, and we should have a vote -- actually 76% of  
 30 the benefit goes to us, but 24% goes to you, you and you and,  
 31 therefore, we should have with our 76% vote, you should have to  
 32 pay 24% of the costs of this investment.

33 So I think it actually might turn out to be that it will be  
 34 very popular to use this mechanism, but it will only go forward  
 35 for investments that would have happened anyhow. But the real  
 36 free-riding problems that it's designed for, it will be very  
 37 hard to get all the people put together to get the coalition.

38 So, I'm very skeptical that that mechanism will overcome  
 39 this free-riding problem.

40 **CHAIR:** Okay, well, I think we might break there; that will give us  
 41 15 minutes, and come back at quarter to and finish at 1.00, and  
 42 that might give us time for questions. Okay, we'll reconvene at  
 43 12.45, thank you.

44 **Adjournment taken from 12.29 pm to 12.47 pm**

45 **CHAIR:** I suggest we reconvene and I'll ask Professor Hogan to  
 46 continue his presentation, and I would like to break at  
 47 1 o'clock without wanting to cut anybody off.

48 **PROF HOGAN:** I'm available at your discretion, at least through  
 49 tomorrow afternoon, so you can decide.

50 Let me try to close, to summarise, on a couple of points.  
 51 The experience that I'm trying to summarise from the  
 52 United States suggests that the importance of having a public

1 interest Regulator who can intervene and make decisions about  
2 market design -- the cost of getting it wrong is enormous. I  
3 think it's very hard to do these cost-benefit analyses that you  
4 have to do, and I sympathise with the task that you have before  
5 you. I don't think anybody, including me, would have  
6 anticipated how bad California would turn out to be before the  
7 fact.

8 I was an outlier. I thought it wasn't going to work, and  
9 said so -- but I never thought it would be as bad as it was.  
10 What happens is you create perverse incentives by changing some  
11 of these Rules in ways that are inefficient and the market  
12 responds, and you can get into a situation as we have, that the  
13 political outcry threatens the whole enterprise. So, I think  
14 that's the more -- the things that I worry about in the  
15 United States.

16 I do think it's -- the evidence there is not consistent  
17 with the view that you don't need a Regulator, you only need the  
18 threat of a Regulator. I think you need an active Regulator,  
19 it's not a guarantee of success but it's important.

20 That doesn't mean that the industry processes aren't  
21 important also, and I've tried to describe how they can be done.

22 I just relate an anecdote about this because last year we  
23 had a conversation about this issue in front of the Federal  
24 Regulators. The Federal Regulators held one of their technical  
25 conferences, which is in the format much like this, and we were  
26 talking about standard market design, and representatives from  
27 the Gas Industry Standards Board came to participate. The Gas  
28 Industry Standards Board is the gas industry group self-  
29 regulated from the industry that sets standards for pressure and  
30 settlements and timing of notification and things like that.  
31 They developed a set of rules which had worked pretty well and  
32 it's viewed as a success of industry self-regulation.

33 They were proposing to create an Electric Industry  
34 Standards Board to set the Rules for the market that would be  
35 evolving in the electricity system. I listened to this and I  
36 was quite alarmed when I heard them making this proposal at a  
37 high level of generality. I was thinking about how to intervene  
38 in this conversation because what I was afraid of was that the  
39 Federal Regulators would view this as the easy way out; if they  
40 could turn the problem over to the Electric Industry Standards  
41 Board and the Regulator could go home early, which is a constant  
42 pressure in this process.

43 I was going to intervene when Mike Dworkin was the first  
44 one, who was the State Commissioner from Vermont and a very  
45 smart gentlemen, who stood up and he said, "Well, wait a minute,  
46 I think an Electric Industry Standards Board run by the industry  
47 is a great idea as long as we don't give him any decisions that  
48 are important", and he said -- there are many areas where we  
49 need a common decision; we need protocols on how to use the web;  
50 we need to decide whether the reports come in red paper or blue  
51 paper; there's lots of things where you have to make a decision  
52 about the forms and the procedures. But anything that's truly

1 controversial, and where there's strong conflicting commercial  
2 interests, this process wouldn't work and it shouldn't be  
3 delegated to an industry self-regulating body, and then various  
4 speakers started jumping in, including me, to reinforce this  
5 view.

6 The most vocal proponent of this view turned out to be not  
7 me or Mike Dworkin, I don't remember the gentleman's name, but  
8 it turned out to be the representative of the Electric Industry  
9 Standards Board proposal, because the last thing he wanted was  
10 to get controversial commercial decisions imposed on him in  
11 trying to run the industry process and make decisions about  
12 that, and agreed completely that they had no capability to  
13 manage that process or to make those decisions, and decisions on  
14 market design, pricing rules and the like were going to have to  
15 be the responsibility of FERC, the Federal Regulator, and the  
16 Federal Regulator agreed with that, I believe, and there was a  
17 happy outcome to that conversation; they were going to use the  
18 industry process where it's appropriate but not where it's not  
19 appropriate.

20 With that I'll close by citing the quote that I put in my  
21 submission from the Wall Street Journal, not exactly a bastion  
22 of pro-Government intervention but the editorial, and referring  
23 to electricity restructuring, quote from Mr Murray, he said:

24 "Deregulation, it turns out, is hard Government work."

25 **CHAIR:** Thank you for your submission. There are five minutes left  
26 for any further questions from Members.

27 **MR CURTIN:** Just coming back very quickly, we had a little bit of a  
28 discussion about the 75% threshold. I suppose your submission  
29 is that the Part F arrangements on transmission in the Rulebook  
30 on getting a decision and paying for it, is your argument that  
31 they're not sufficient to get round the free-riding and  
32 collective decision-making problems that arise in paying for  
33 transmission investment?

34 **PROF HOGAN:** I think it will have two effects. I think it's  
35 insufficient to solve the problem based on the experience we've  
36 had in the United States, and I think it undermines, to some  
37 extent, the intent to have merchant investment in transmission  
38 to make people -- have people investing in transmission on their  
39 own, because they can always go back to this process and pick up  
40 an additional subsidy from this process of having the 75% vote.  
41 I mean, anybody who gets -- if I have a transmission project  
42 where I think I'm the principal beneficiary, and it would be  
43 clearly economic for me to invest, and most of the benefits come  
44 to me, but the nature of transmission is such that there will be  
45 spill-over benefits to other people. It's almost unavoidable  
46 that there are spill-over benefits to other people, that's one  
47 of the problems here.

48 With this process I think I would be crazy not to come in  
49 under the Rule that says we need to get all of the beneficiaries  
50 in and make everybody pay, and assign it in proportion to the  
51 benefits; I get 80% of the benefits so I get 80% of the votes.  
52 The other 20% are out there, they should pay. It will be mirky

1 about whether or not they really do get benefits for them. It  
2 will be very hard to be sure about that, it will be highly  
3 controversial, but eventually I get down there and I get 80% and  
4 I get the other 20% to help pay for it, it wouldn't be a  
5 surprise to see that happen.

6 This didn't happen with Trans Energy in the  
7 Connecticut/Long Island. They don't have any authority whatever  
8 to get anybody else to pay for it and if they wanted to do it  
9 under a procedure like that then they'd have to be a regulated  
10 entity and make a regulated investment and have a regulated  
11 return, and they didn't want that. So they didn't have this  
12 option of forcing people to pay but have it be an unregulated  
13 venture.

14 **MR CURTIN:** Just one final one. One of the -- in the Draft  
15 Determination, when we're doing the cost-benefit analysis, we  
16 have a line item in there looking at the costs of -- arguable  
17 costs of over-investment by the transmission provider under a  
18 system where they can go to a Regulator and basically have a  
19 Regulator impose the cost on the users, and in that circumstance  
20 the engineering ethos that you talked about before arguably  
21 would come out of gold-plating and all the other stuff that  
22 people worry about in situations like that.

23 We've been talking a little bit about how the applicant's  
24 arrangements would apply, but would you care to comment on that  
25 finding in the Draft Determination, the transmission provider  
26 with some kind of preferential access to the Regulator and the  
27 ability to impose costs, why would they not let the engineers  
28 run all over the country building transmission facilities in  
29 those circumstances more than might be optimal?

30 **PROF HOGAN:** Well, they might. There's no guarantee that that  
31 won't happen and there is some incentive to do that.

32 What I've been recommending in the United States, and this  
33 is a hard idea to get across, but I would recommend it here as  
34 well, is when you create the financial transmission rights  
35 market, which you haven't done yet, and you start having  
36 property rights that you can give for transmission investment,  
37 then the special cases when you need the regulated investment  
38 are only those cases where there is a large market failure that  
39 produces a big free-riding problem.

40 So, you should only allow these regulated investments to go  
41 forward when the applicant can demonstrate that there's a  
42 large -- to the Regulator -- that there's a large market failure  
43 and here's the large free-riding problem.

44 I think that eliminates a lot of investment in  
45 transmission. It doesn't meet that test. If it's economical to  
46 do the beneficiaries can capture the benefits and the financial  
47 transmission rights and so they'll do it; and if they won't do  
48 it, you know, "Are you sure it's really a good idea?" and so  
49 it's a threshold that they would have to jump across to  
50 demonstrate that there's this large free-riding effect.

1 I think that -- it doesn't eliminate everything but I think  
2 it helps a lot in mitigating the problem that you're talking  
3 about.

4 The second part is just general sense of this, it's just so  
5 hard to build transmission. I don't think it's easy here  
6 either, and I just don't get the sense of the problem that we're  
7 watching a lot of transmission being built under these regulated  
8 entities, quite the contrary in the United States. The  
9 regulated industries are very reluctant to build because they  
10 are not at all sure about the returns that they're going to get  
11 for this, because of the uncertainty that's associated with  
12 that, with the changing market rules and whether or not they get  
13 FTRs and how that's going to work.

14 So, the Department of Energy completed a big study of this  
15 recently and the sense of it was that they have this graph that  
16 everybody produces about the declining investment and declining  
17 transmission assets per unit of output of the system and that  
18 kind of thing, so it's going down in their areas where Southwest  
19 Connecticut is a good example, New York City, San Francisco,  
20 Northern California, going into the Midwest where there are big  
21 transmission bottlenecks and nobody wants to pay to expand them.

22 **MR CURTIN:** Thank you.

23 **MS REBSTOCK:** I know I made the comment earlier, but it seems to me  
24 we're not starting from scratch here, we've got Rules that we're  
25 looking at, that a vast majority of them have been in place now  
26 for a number of years.

27 The regulatory environment here has been one that we don't  
28 say that, because there's a potential for a problem, we'll  
29 assume it will happen, therefore start with the prior view that  
30 regulation always is necessary even if -- just because the  
31 conditions might be conducive to the use of market power in this  
32 situation where we've seen, I don't know how many years these  
33 Rules have been in place, but probably four years, we have not  
34 had clear evidence that there's been abuse of market power.

35 So, we have rules that, as you said yourself, were working  
36 reasonably well. It seems a little higher threshold to get over  
37 in the New Zealand case to then say we'll put in place  
38 regulation that, from what you have told us, needs to be fairly  
39 intensive regulation in order to do it properly. In a country  
40 of four million people that represents a serious cost. It can't  
41 be spread over 200 and 300 million people like it can in the  
42 United States.

43 So, I just wonder whether really if the trade-offs for us  
44 aren't slightly different than they might be in the  
45 United States, particularly in light of where we're starting  
46 from, a set of rules that have demonstrated their effectiveness  
47 over a number of years.

48 So, I'd welcome your comment on that.

49 **PROF HOGAN:** I'd much rather be starting where you are than where  
50 we are with the exception of PJM in New York, and now  
51 New England, but certainly California sees the struggles they're  
52 going through in the Southwest and the West, the problems that

1 have cropped up in Texas, which I haven't talked about, so  
2 that's a great asset that you have.

3 It is true that New Zealand is a smaller area than some of  
4 these places in the United States and the cost is not trivial of  
5 doing this. I don't think it's too onerous but it's not trivial  
6 by any stretch of the imagination. So it's a trade-off, that  
7 you absolutely have to make a judgment about as to what's the  
8 trade-off.

9 What I was responding to, what I read in the application,  
10 was the description of benign industry processes that always  
11 work because why wouldn't they make a decision that was in the  
12 collective interest of everybody? Why would they go to the  
13 least common denominator, it doesn't make sense. They should  
14 make good decisions and I cited Douglas North, who was a Nobel  
15 Prize winning economist who used to have this view until he was  
16 overwhelmed by the evidence, and the experience in the  
17 United States -- I was skeptical about this in 1995, I'm now  
18 convinced that it doesn't work.

19 **MS REBSTOCK:** You could have had the opposite experience here. You  
20 could have started thinking, "There must be a problem here, you  
21 need a Regulator", but you put in place a set of rules with no  
22 Regulators, let it run for several years and come to the end and  
23 say, "I've been convinced just the opposite", couldn't you, if  
24 you focused on our experience as opposed to the Californian  
25 experience?

26 **PROF HOGAN:** Absolutely you could and, in fact, not only is that a  
27 hypothetical that you could imagine, it's actually what  
28 happened. So the argument was made quite often, "Well maybe  
29 this isn't perfect, it won't work in theory. Thank you very  
30 much, professor, but we think it will work in practise, and so  
31 we're going to do it our way and if it doesn't work we can fix  
32 it later."

33 I'm sustaining that our experience has been very unhappy  
34 with that approach, that we have observed enormous expense in  
35 that, that way outweighs anything that would have been the cost  
36 of regulation -- the administrative cost of regulation itself,  
37 and it has threatened the whole enterprise.

38 That means California is the fifth largest country in the  
39 world, it went from surplus to deficit.

40 **MS REBSTOCK:** On that point, I did note down that comment you made  
41 at the beginning, and you may be aware in the Draft  
42 Determination we did look at whether the backstop of regulation  
43 actually meant that the detriments were lower, and that's in  
44 effect been the argument put to us, that because -- even if  
45 things go wrong, the Government can then regulate, and so, the  
46 detriments aren't as high.

47 But I actually hear you saying that, if things go terribly  
48 wrong you won't end up with the same regulation you'd start with  
49 if you put it in place from here on, and that the costs of that  
50 regulation then would be greater than it would otherwise be.

51 Is that a fair statement?

1 **PROF HOGAN:** I think that's a very fair statement and it's a better  
 2 way of saying what I have been saying about the cost-benefit  
 3 analysis, and I think it's a matter of great concern for us --  
 4 and we haven't made it through this tangled process ourselves --  
 5 but there's a very strong danger that we're going to end up with  
 6 a very bad regulated system in the United States.

7 Now, the Federal Regulators recognise this danger and are  
 8 working very hard to avert it, but it's not guaranteed by any  
 9 matter.

10 **MS BATES:** Can I ask you a question about private investment. It's  
 11 been suggested to us, and it is a view we've heard before, that  
 12 regulation and the attendant possibility of unpredictable or bad  
 13 decision-making on the part of the Regulator is a disincentive  
 14 to private investment and, therefore, is not in the public  
 15 interest.

16 I'd just like you to comment on that proposition and say  
 17 whether you've in fact found that to be the case from your  
 18 experience in cases where regulation has come into play.

19 **PROF HOGAN:** Uncertainty about the Rules is a powerful disincentive  
 20 to investment, and it can come from any of a number of sources,  
 21 including the possibility of regulation. The pressure from the  
 22 marketplace today in the United States is pushing very hard to  
 23 try to get the Regulators to get these standard market designs  
 24 in place, to get the regional transmission organisations in  
 25 place so that they have good market design and the endless  
 26 conversation gets over, so that they know what it's going to be  
 27 like and they can make investments, and the delay that's going  
 28 on and has been going on with the industry processes and  
 29 stakeholder processes, particularly in the Midwest and the  
 30 Southeast, has hampered everything.

31 **CHAIR:** Well, I'd just like you to thank you for your submission,  
 32 and also the fact that you've been very frank with us; you've  
 33 certainly given us something to consider. I gather you will be  
 34 here tomorrow so, if any Commission Member would like to give  
 35 you a call I'm sure that is possible. Anything I think, though,  
 36 if you were able to supplement what you have said with anything,  
 37 we would like to circulate it around to the rest of the parties,  
 38 that's an important part of our process.

39 So, do you have any notes available or were you speaking  
 40 basically to the notes that were attached to the submission?

41 **PROF HOGAN:** I have an outline for myself to guide my thought for  
 42 today, but it's basically the submission is the points, and the  
 43 paper that I mentioned about electricity restructuring reforms  
 44 of reforms, I don't know if it was cited but it wasn't attached,  
 45 and I suggested yesterday that you could print it off the web,  
 46 but somebody could make it available to you.

47 **CHAIR:** We might do that, because I'd like to circulate it to  
 48 parties who would have an opportunity to consider it, and if you  
 49 were making any other comments on inquiry, I'd like those  
 50 circulated as well.

51 On behalf of the Commission, thanks for your time and being  
 52 willing to take questions and for your experience. Thank you.



*Transpower*

1 I'd like to break now and reconvene at 2 o'clock sharp  
2 because WEL, the next presenters, only have the hour, so back at  
3 2.00. Thank you.  
4

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6

**Adjournment taken from 1.07 pm to 2.05 pm**

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1 **CHAIR:** Right, we'll give Mr Underhill time to try and get his  
2 papers out.

3 I just welcome WEL to the Conference. Just a couple of  
4 points on process. We'll attempt to be as informal as we can  
5 and, obviously, give the submitters every opportunity to put  
6 their point of view.

7 We'll restrict questions to Commissioners rather than from  
8 the floor generally and prefer, obviously, that submissions be  
9 made in public. If there's any confidential information you  
10 have to present we will, of course, take it in a confidential  
11 session, but ideally would prefer that submissions be before the  
12 public.

13 So, without further ado, just to welcome Mr Underhill and  
14 his colleague, it's over to you, please.

15 **PRESENTATION BY WEL NETWORKS**

16 **MR UNDERHILL:** Thanks very much.

17 Thanks for having us here this afternoon. We came here via  
18 the pro-competitive airline industry and were 55 minutes late  
19 and suffered great customer service.

20 I'm Mike Underhill, I'm the Chief Executive of WEL Networks  
21 and on my left is Kevin Palmer, our Chief Financial Officer. We  
22 made a submission and made a response to the Draft  
23 Determination. John, we don't have many points to make but  
24 we'll make those briefly and take it from there.

25 **CHAIR:** Thank you.

26 **MR UNDERHILL:** WEL Networks is a trust owned line company. We  
27 operate in Hamilton and the surrounding Waikato. There are  
28 74,000 customers connected to our network, and we come with a  
29 line company perspective.

30 From a personal experience point of view, I've had 30 years  
31 in this industry, in the gas industry, have been involved in a  
32 number of the reform initiatives over the past 15 years. I'm  
33 also Chairman of ECA, but I'm not wearing that hat today; they  
34 have made a separate submission, so I'm making this submission  
35 purely as WEL Networks.

36 So, if I could start. I start from the premise that this  
37 industry has needed to have changes and although we've enjoyed  
38 15 years of virtually constant change, the change was needed.  
39 But the points I want to make lead up to some of the views I'm  
40 going to express today.

41 The industry has made some significant changes, and  
42 actually it still has some way to go, so I'm saying that there's  
43 a way to go before we've reached perfection or anything like  
44 that. The challenge I see, looking ahead and looking at this  
45 form of industry governance and hence the application of the  
46 authorisation is, we've actually had 55 major reforms since  
47 1988.

48 When I look at the cost to the industry from an industry  
49 participant and then the cost to the Government, because it's  
50 initiating these, then I think a bit of wisdom needs to be  
51 applied as to the efficiency of that type of process of getting  
52 change in the industry.

1           So, when I look forward I look back to say, "Where have we  
2 come from?" and look at the performance of the Government as an  
3 initiator of restructurings and reforms that needed to take  
4 place.

5           My view is reforms did need to take place. If I was to say  
6 very simply, I think generally the process has been pretty  
7 appalling. I think the measure of that, in terms of the impact  
8 on customers, has probably also been pretty appalling if you  
9 look at it how the customers probably perceive this industry  
10 today.

11           So what I hope, in looking forward, is that we can move on  
12 from the constant restructuring process and get a stable  
13 industry structure and stable governance process to allow it to  
14 go forward.

15           So, when I look forward, I look back with some considerable  
16 concern at the cost and the opportunity costs to this industry  
17 of going through the process that we have in the past 15 years.

18           By the opportunity cost, I don't just mean obviously the  
19 direct costs, but when I look at the foregone opportunities in  
20 innovation, customer service, new technology that have been put  
21 aside as the governance and management of the industry  
22 participants are focused on, whatever the former initiative is  
23 in front of them, and then the transition process that's gone  
24 on from there, and then the inevitable teething problems that  
25 occur with that, and then the inevitable expectation of a  
26 further Government reform to fix what has gone wrong. I just  
27 say, "Thank goodness I live in Hamilton and not in Wellington  
28 because, if this is the weather you have, no wonder the  
29 Government's slow."

30           So, I want to make that point, and so when I look forward  
31 and say, well, looking at this proposal, this proposal has  
32 changed quite significantly from the initial objective, in my  
33 view, and in my view it was one that industry self-regulation  
34 or industry participants look to regulate the industry to get  
35 the best outcome, and if there was uncertainty as to what the  
36 outcome should be, then there was clear opportunity for  
37 Government direction via Policy Statements and other mechanisms  
38 to set the direction for the industry.

39           One thing I would say is, historically, despite my words  
40 just before, the city has tended to respond pretty well to  
41 Government direction.

42           So, in looking forward it seemed to me that this form of  
43 governance, even though the format that's in front of you now  
44 does not have the purity and, hence, not the same strength of  
45 incentive to perform as it initially had, I still believe it's  
46 better than what we have had, and I believe the alternative to  
47 this is the Government EGB and examining how I believe that  
48 might operate; I believe it would have contained a significant  
49 amount of the way the Government currently operates in terms of  
50 pushing reforms forward.

51           So, I believe an industry led governance process has more  
52 incentives to respond quickly and effectively than a Government

1 driven reform process going forward and a Government driven  
2 governance process.

3 So I just want to make those general comments, and I just  
4 want to comment on two things that came out of the Draft  
5 Determination.

6 The first one was a concern about transmission investment  
7 and looking at the voting strength of line companies, because  
8 generally transmission investment is driven more by connection  
9 through to distribution at the generation end.

10 In my view, I believe that the line companies have a very  
11 strong interest in terms of the security of supply to their  
12 networks and, without being rude to any of my Transpower friends  
13 in this room -- and I don't think I see any -- I think the  
14 trouble has been that the desire from the line companies for  
15 transmission investment has probably been stronger than the  
16 transmission desire for that.

17 And, by example, I'm saying that to say that I do not  
18 believe you'd see a lines company voting against transmission  
19 investment where security of supply was involved.

20 As far as our own company is concerned, we have initiated  
21 significant Transpower investment, which we all pay for, to put  
22 a new point of supply west of the city of Hamilton to overcome  
23 what we believed were significant shortcomings in security of  
24 supply at the transmission level.

25 In terms of system constraints, which I think is the other  
26 area of concern about transmission investment; from our own  
27 experience we are motivated to ensure that these transmission  
28 constraints are minimised because, again, we see the  
29 consequences of that in terms as the local lines company.

30 The interesting thing, just to finish off, that I want to  
31 say is that this particular self-regulation and the Rules that  
32 come under it do not have too much direct impact on line  
33 companies. We're affected by model use of system agreements and  
34 methods of pricing of lines. The point I want to raise here is  
35 that in parallel with this we're probably going to appear in  
36 front of this same panel in about a month's time in terms of the  
37 control of lines companies, and there are some very significant  
38 issues there.

39 If I can be cheeky to encourage the Commission to have some  
40 wisdom in looking at the different strands of electricity  
41 regulation and governance to ensure that we don't get  
42 duplication occurring, and also that -- and I know in some areas  
43 the Commission is simply discharging the requirements of  
44 Government -- it would be useful if the wisdom of the Commission  
45 could, perhaps, give some feedback to Government if the form of  
46 regulation interrelated with this form of self-regulation under  
47 this industry governance process, if there's anything that --

48 **MS REBSTOCK:** What is it you have in mind? What are you  
49 specifically referring to?

50 **MR UNDERHILL:** What I'm saying is there's considerable opportunity  
51 under the development of the Rules to cover the performance of  
52 lines companies and there's an opportunity to let that develop;

1 at the same time under this industry -- at the same time under  
2 the control of the industry there are a whole series of process  
3 for thresholds, price control etc addressing somewhat the same  
4 issues, and I just hope that the overlap is acknowledged and  
5 there isn't duplication of that.

6 **MS REBSTOCK:** I'm just trying to understand where you see the  
7 overlap.

8 **MR UNDERHILL:** Well, where I see the overlap is in two areas that  
9 are already being looked at under this process; the use of  
10 system agreements and pricing methodologies.

11 The pricing in particular is going to be a key issue coming  
12 under the thresholds and the eventual price control of lines  
13 companies if they fail to meet those thresholds.

14 **CHAIR:** I think, without belabouring the point, Mr Underhill, it  
15 would be useful to us, I think -- and no doubt to you and  
16 others in relation to the threshold issue, which as you say is  
17 jurisdictionally separate from what we're doing today -- some of  
18 those linkages, no doubt, will be made as part of people's  
19 submissions to that hearing, so we'll certainly be encouraged to  
20 hear about it.

21 Sorry, I've interrupted your train of thought.

22 I mean, would you care to go back and speak a little on the  
23 voting procedure issue before we open up for questions or...?

24 **MR UNDERHILL:** Sorry, just make that point again?

25 **CHAIR:** Would you prefer to speak a little more on the voting  
26 responses issue and then we can open it up for questions, if you  
27 like?

28 **MR UNDERHILL:** Certainly.

29 As I understood, one of the concerns was the fact that the  
30 majority of voting in terms of transmission capital expenditure  
31 was likely to come from line companies in a number of  
32 circumstances, and the concern that we, as line companies, would  
33 vote against such an investment to the detriment of the public  
34 good.

35 The issue as we see it is that as a line company we're very  
36 strongly motivated towards the performance of our network, and  
37 the performance of our network is very strongly linked to the  
38 performance of the transmission network.

39 As a line company we're generally hidden from the public  
40 view and the only way we catch the public's attention is to turn  
41 their lights off, which is not something we intend to do very  
42 often and, in fact, don't do very often.

43 We take very seriously anything to do with security of  
44 supply. The majority of new investment in our network is  
45 security supply related and we expect the same from the  
46 transmission network.

47 So, we would respond very strongly to any issue where  
48 investment was being considered, yes or no, where the benefit  
49 was the improvement in security of supply. And talking to my  
50 colleagues in other line companies, they would take the same  
51 view.

1           So you put a challenge in the Draft Determination, I think  
2           there's a strong incentive on line companies to support such an  
3           investment decision being considered.

4   **CHAIR:** Well, I open it up for questions.

5   **MR CURTIN:** Just on this issue of paying for a transmission  
6           investment, you've quoted an example in your submission of bits  
7           and bobs you'd like put in and you'll pay for. But the evidence  
8           to date has been that that appears to be very much the  
9           exception, and that for various reasons of freeloading and all  
10          the rest of it it's exceptionally hard to come to a firm  
11          decision on paying for transmission investment.

12          What made it possible for you to reach an outcome here that  
13          doesn't seem to be happening more widely on the submissions we  
14          received?

15   **MR UNDERHILL:** Well, I'll use the example in Hamilton. We were  
16          very concerned to see that in about four years' time there would  
17          be an inadequate security supply to the city of Hamilton. We're  
18          predominantly supplied from one point and that if anything  
19          should happen to that point the city would be out of power until  
20          whatever it was was fixed.

21          When we looked at the debates that have taken place in the  
22          past with regard to security supply, and the solution has been,  
23          well, "we'll turn the hot water heating off for customers" type  
24          solution, that seemed to pale when the modern way of looking at  
25          things is in fact how you give supply to customers and give good  
26          service to customers.

27          I have to say it didn't take us very long, when we did our  
28          load forecasting in looking at the security issues we faced, to  
29          come to that decision. It's probably the major -- not probably,  
30          it is the major investment decision that this company's made for  
31          the past 12 years in terms of looking at security of supply, and  
32          we're asking another party to make that investment.

33          I think what I would say in terms of line companies is that  
34          when you look at their focus since the split of them being a  
35          retail and a line company, security of supply becomes the  
36          dominant driver because it's the way in which you most impact  
37          the customer.

38   **MS BATES:** Could I clarify one point; who was paying for that  
39          investment in Hamilton?

40   **MR UNDERHILL:** Umm -- [holds hand up in the air]

41   **MS BATES:** Just you?

42   **MR UNDERHILL:** That's correct. And it's a new point, directly  
43          supplying our region, so we're not looking at a wider situation  
44          where it affects more than one company.

45   **MR CURTIN:** Do you think that that's one of the reasons, perhaps,  
46          that it's been able to happen in your case, because there is  
47          just one potential beneficiary on one side?

48   **MR UNDERHILL:** Well, that certainly made the decision-making on, if  
49          you like, the user side easier.

50          I think the point I'd make is that, if there was a  
51          regional benefit for that, talking to our neighbouring lines  
52          companies, they would respond similarly.

1 **MR CURTIN:** I think we've had evidence, I think on the first or  
2 second day, somebody instanced the Auckland security of supply  
3 situation as an example in the opposite direction that, you  
4 know, crises have happened and there's still not joint agreement  
5 among people who you would expect to be immediate beneficiaries,  
6 and actually there's been a lot of debate about whether the new  
7 Rulebook helps to solve those sorts of issues or otherwise.

8 But your single buyer example suggests that, yes, you can  
9 make the present situation work, but the Auckland situation  
10 would suggest there's still a problem there.

11 **MR UNDERHILL:** And I think it's fair to say that because the more  
12 participants there are making the decision, the more difficult  
13 it becomes. And when you argued the Auckland issue, how many  
14 demand side participants are the beneficial parties and hence  
15 where does the responsibility lie, and where does that fit as  
16 opposed to a spur off the main transmission grid versus the main  
17 transmission grid itself?

18 Yes, it's a far more difficult issue, in my view, if the  
19 judgment is, well, actually, this is a backbone transmission  
20 grid which is part of the responsibility of Transpower to ensure  
21 it has sufficient security and capacity.

22 **MR CURTIN:** Do you think Part F of the Rulebook will, in your  
23 opinion, solve those kind of issues or not?

24 **MR UNDERHILL:** In my view it will be a considerable step forward  
25 from where we currently are.

26 The process of getting industry participants through a  
27 third party, or otherwise through working parties, to consider  
28 issues can be a lengthy process, but it's an exhaustive process  
29 and it's generally delivered outcomes, looking backwards in  
30 terms of other areas, which I believe could not have been  
31 achieved without that sort of a process.

32 My view is, yes, it is a step forward. It will be a time-  
33 consuming and difficult way forward but it will produce a  
34 solution which, I think, our history has shown we don't produce  
35 in some of these areas.

36 **MS BATES:** Can I go back to your Hamilton investment. Were you  
37 able to recoup any of the costs of that in charges?

38 **MR UNDERHILL:** We're talking about the future now --

39 **MS BATES:** Or are you intending to? I mean what sort of economics  
40 are behind it?

41 **MR UNDERHILL:** The economics behind this are that we will not sell  
42 one more unit of energy -- not one more unit of energy will be  
43 sold through this, so this is purely a security of supply issue.  
44 We are driven overall by the return we get on our network and  
45 the service we give the customers, and in our financial forecast  
46 through this period we haven't seen that as driving the price up  
47 through the improvement of security of supply.

48 **MS BATES:** So, you won't be putting the price up as a result?

49 **MR UNDERHILL:** You're getting me to say this now in front of the  
50 media?

51 **MS BATES:** Yeah.

1 **MR UNDERHILL:** In terms of our financial forecast -- just taking a  
2 serious response to that question -- that isn't an issue that  
3 would drive our price up, looking at our capital investment and  
4 the rest of our financial forecast.

5 **MS BATES:** I'm only asking you because I'm testing the likelihood  
6 of inducements being made where there isn't a prospect for  
7 economic return in the usual way.

8 **MR UNDERHILL:** And what I'm saying is that, we have two measures  
9 because we -- in terms of return, we seek to get a whack plus a  
10 margin return on our business, so we're looking closely at the  
11 economic return we make.

12 But I have to say, it's one of the absolutes that we  
13 deliver supply in a prudent manner. Our view very clearly came  
14 that, after three years' time we could not look the people of  
15 Hamilton in the eye and say we could deliver supply in a prudent  
16 manner unless this investment was made.

17 **MS BATES:** Do you have to take a long-term view then?

18 **MR UNDERHILL:** In our industry, we're a 40 or 50 year industry, all  
19 our decisions are long-term views, including our future revenue  
20 streams, our profit margins and the value of the business.

21 **CHAIR:** Can I go back to your earlier introduction, really. I  
22 guess the strong message we're getting -- and one assumes lines  
23 companies generally are of the same view -- is, frankly, to get  
24 the current process sorted out and to get on and make some  
25 strategic decisions, particularly from your point of view, from  
26 the security perspective, which raises another point; some of  
27 the submissions we've had so far, there does seem to be in the  
28 minds of some trade-offs between security and the ability to run  
29 an innovative market.

30 Now, in your view, the security issue would override more  
31 market structure development aspects?

32 **MR UNDERHILL:** I suppose, if I just give a general view. Unlike  
33 some, I actually think it's quite a simple industry with three  
34 simple things to do. We're there to supply electricity to the  
35 final customer, and I just see a three-way test: 1) do the  
36 lights stay on -- that seems to be a security issue; 2) is the  
37 price competitive, fair or whatever measure you're going to do;  
38 3) is there some service you give to the customers to this  
39 process?

40 When I look at it as simply as that, and I think it  
41 sometime helps to look at it as simply as that, then the  
42 security of supply becomes a critical part of the whole  
43 equation, and if there are trade-offs to make you don't go and  
44 play with one of those three driving principles very lightly at  
45 all.

46 Obviously there are all sorts of trade-offs you can make  
47 between security of supply and other opportunities. In my view  
48 our industry would be most judged on piling on security of  
49 supply.

50 I've waffled on that answer, I'm sorry.

51 **CHAIR:** No, I'm trying to get a balance there.



1 **MS BATES:** It's interesting, because the applicant has put to us  
2 the proposition, I think, that under a Crown EGB there would  
3 likely to be over-emphasis on the security of supply and  
4 investment and the transmission to achieve it.

5 Do you agree with that view?

6 **MR UNDERHILL:** No, I don't.

7 I'm almost as old as John, but I can recall, seriously,  
8 looking back --

9 **CHAIR:** That's getting pretty old, Michael.

10 **MR UNDERHILL:** But I can recall in the time I've been in this  
11 industry, and looking back in the history with Government owned,  
12 Government controlled, and the Government involvement, we have  
13 had a terrible history of security. Every 10 years the lights  
14 have gone off. So, there were parts of the country where the  
15 transmission system required whole days off -- not too far back  
16 in our history.

17 So my view is, I don't like the model we've had and when we  
18 say "a Crown EGB" I see a number of elements of the previous  
19 model coming through. I think we can do better than that.

20 **MS BATES:** What are those elements you see coming through and why?

21 **MR UNDERHILL:** Okay.

22 What I see coming through is, in terms of the Government  
23 putting direction through to a Crown EGB and setting the  
24 mechanisms you involve the whole panoply of Government and  
25 officials in this process, and I don't think that's an effective  
26 way of going forward because they're not exposed to the same  
27 pressures that the participants of the industry are.

28 So, I think the sort of thinking process that goes through  
29 there is a very long-winded slow process without direct exposure  
30 to the consequences of being involved in that process.

31 **MS BATES:** But I put it to you, it doesn't necessarily have to be  
32 set-up in that way. If you get a Crown EGB with the right  
33 degree of expertise and representation there, then it could run  
34 pretty well with the Minister.

35 **MR UNDERHILL:** The answer is, it could run pretty well with the  
36 Minister. I'm just concerned about how it would run, rather  
37 than it could run.

38 **MS BATES:** But you are talking about the question of officials, so  
39 you see them being interposed between the Crown EGB and the  
40 Minister. Do you think the Minister would need the officials to  
41 say whether the recommendation given by the Crown EGB was  
42 correct? I'm just trying to --

43 **MR UNDERHILL:** I'm trying to see who's in the room.

44 The answer is "yes", absolutely yes, that I see officials  
45 are absolutely necessary to give advice to the Minister; as  
46 public servants that's what they do.

47 **MS BATES:** But isn't that what the function of Crown EGB would be,  
48 to give advice to the Minister to make recommendations to the  
49 Minister?

50 **MR UNDERHILL:** That's correct. And sitting in and mirroring that  
51 advice and considering that advice, for the Minister to receive  
52 it would be the relevant Government officials doing that.

1 **MS BATES:** That's helpful, I just wanted to see where you were  
2 getting to on that.

3 **MR UNDERHILL:** I've worked with a fair few officials over the  
4 years, and it's just the process they have to go through. I  
5 just feel it's long-winded, can be unfocused and not facing the  
6 same incentives that the participants in the industry do.

7 **MS BATES:** Let's look at the other side of the coin for a minute  
8 and look at the industry EGB, and you know that under the  
9 legislation the Minister sets the objectives and looks at  
10 outcomes. Well, would officials not be also --

11 **MR UNDERHILL:** Yes.

12 **MS BATES:** -- involved in that process and wouldn't you have the  
13 same problems that you're talking about?

14 **MR UNDERHILL:** I think where I'd say the difference was was this:  
15 Every so often you would have a direction from the Minister  
16 coming through with as much official support as he needs, but I  
17 see that as a setting a direction type input rather than a  
18 consideration and in real time having to come to a view type  
19 input. I think that's the difference.

20 I'd have to say, I think there's a very necessary role for  
21 the Minister, to set directions in this industry that may not be  
22 the same view as other participants in the industry, and,  
23 frankly, I think the directions being set this time by this  
24 Minister and his officials, credit where credit is due, is  
25 exactly the right focus.

26 If I can just say one further thing. I think one of the  
27 things that's characterised the past 15 years of this industry  
28 has been viewed as a relationship between industry participants  
29 without any reflection that actually we're an industry supplying  
30 the final customer, and this is the first statement from  
31 Government in 15 years that actually has used the customer  
32 word, which has caused some consternation.

33 **MS BATES:** I can see that it has, yes.

34 **MR UNDERHILL:** But isn't that why we're here?

35 **MR CURTIN:** Just by way of clarification, more than anything,  
36 talking about the voting provisions and how you have better  
37 ideas, and you know that EGEN had asked its Working Group to do  
38 something about it, and you believed that EGEN and the Working  
39 Group can put forward a proposal; were you referring to the  
40 extra conditions that were offered via Russell McVeagh to the  
41 applicant to us since you wrote your application or did you have  
42 other changes to the voting provisions in mind?

43 **MR UNDERHILL:** No, and I should have stated at the start, and I  
44 apologise, that I am a member of that Governance Working Group,  
45 which is one of the Working Groups that supports the whole EGEN  
46 process, so I should have stated that at the start and I  
47 apologise for that.

48 At the time I wrote that I didn't know that was the  
49 outcome, but I was confident that an outcome of that sort could  
50 be arrived at and I supported that outcome; that presumably has  
51 been put through to you and I haven't read whatever the final  
52 thing that's been put through to you is. It seemed to me that

1 on pro-competitive issues, where there was any concern, there  
2 must be a way to break the impasse so that pro-competitive  
3 issues can be addressed properly.

4 **MR CURTIN:** Do you have -- would you care to sort of expand a bit  
5 on what you see those sort of circuit breakers -- or extra  
6 governance tier, or whatever it would be would look like?

7 **MR UNDERHILL:** It was simply that the board could actually make the  
8 decision having given the industry a couple of cracks at the  
9 issue, then clearly if the pro-competitive issues in their  
10 judgment have prevented a satisfactory vote -- and there's a bit  
11 of a challenge for them to come to that view -- there is a  
12 method to do that, and that stops the endless circulation and  
13 nothing coming through.

14 **MR CURTIN:** Thank you, I just want sure about the timing of things.

15 **MS REBSTOCK:** We've heard the customer mentioned more times in the  
16 last 15 minutes than we probably have for most of the  
17 Conference, but I ask you the question; I mean, I hear you  
18 saying that this proposal would yield clear benefits to the end  
19 consumers, yet we don't seem to have too many consumer  
20 representatives supporting the proposal, and I just wonder how  
21 you reconcile those two. It's a very simplistic way to look at  
22 it, but at the end of the day most people can see where their  
23 interests lie, and the consumers don't seem to be coming in  
24 before us and saying this will meet the requirements in the Act  
25 to meet the long-term interests of consumers; they're saying to  
26 the contrary. And it's not necessarily because it's an industry  
27 proposal, in some cases they are like -- they like that part and  
28 in some cases they don't, but it's to do with the specific  
29 proposal before us.

30 So I would be interested in your view on how we find  
31 ourselves in that situation.

32 **MR UNDERHILL:** Well, the first one, I don't apologise for using the  
33 customer word more times in the last 15 minutes than however  
34 long beforehand, because I go back to the point that this is a  
35 simple industry with simple outcomes and they're person measured  
36 at the customer end, and the reason we've had 15 years of  
37 endless and hellish expensive reform is because we haven't had  
38 that focus.

39 So, moving on from there. If you are a customer group you  
40 would say, "Well, what has this industry achieved with all this  
41 reform they proudly boasted about over the last 15 years that  
42 have benefitted me as a customer?" you'd say I was promised  
43 reduced prices yet the prices do seem to have gone up; I was  
44 promised greater ease of dealing with my retailer or whoever it  
45 is, and I can't even ring them up now; the media is blowing up  
46 all sorts of terrible stories of terrible service to customers.  
47 I can believe that customers would think that, well, this is an  
48 industry with a terrible performance and you're gonna trust this  
49 industry to take it on a head. So that's the first point.

50 The second point is, let's look at the Rules and see how  
51 many of these Rules deal with customer issues, I mean final  
52 customer issues. What you will find is that in the chapters

1 there's a chapter called "customer something or other", it  
2 doesn't have too much pages in it.

3 **MS REBSTOCK:** We had noticed that.

4 **MR UNDERHILL:** Okay. So, if you're looking from a customer point  
5 of view you will say, "Give me some faith in the way forward."  
6 let's see how many pages there are in this customer section --  
7 and even though I've been around a long time, I'm actually not  
8 taking a cynical view here -- there is a genuine need for those  
9 pages to be filled and there's a genuine recognition in the  
10 industry, for which I'm part of, that those pages will be  
11 filled.

12 What we have in this process, and what's in front of you,  
13 are three sections of basically an existing rules structure that  
14 come through and are being forward as to, this is the Rules  
15 where they currently exist. So, I'm saying you need a bit of  
16 faith to look at the chapters, the one I identified and are  
17 still to be written.

18 The other point is that I actually welcome the fact that  
19 there are customers in the process -- and to say we've had some  
20 robust debates in one of the Working Groups because of the  
21 customer participants would be an understatement -- and I think  
22 that helps to bring a different perspective on there.

23 So my view is, when I look back on the 15 years, this is  
24 the first time that customer involvement has taken place, where  
25 do you start from, you've got to start from the somewhere; I'm  
26 actually confident that there is an opportunity for customer  
27 groups to have impact on this process, and I'm confident the  
28 industry might finally start thinking about the customer.

29 **MS REBSTOCK:** Sounds like an argument for customers to have some  
30 representation in terms of the voting structure.

31 Did you support that?

32 **MR UNDERHILL:** My belief had been that when you'd got to the  
33 customer chapter which dealt with customer things, then  
34 certainly they should, and when you look --

35 **MS REBSTOCK:** They shouldn't have voting rights?

36 **MR UNDERHILL:** On the sections that affects them.

37 **MS REBSTOCK:** What part of the electricity industry doesn't affect  
38 end-users?

39 **MR UNDERHILL:** Ultimately then, the industry is just there for end-  
40 users. In terms of some of the issues upstream, there's probably  
41 issues, in my view -- and although I've used this "customer"  
42 word -- that are best addressed by the participants at that  
43 stage, what I believe is, because this missing chapter hasn't  
44 been populated, that that's the area where the outcomes of the  
45 industry are looked at.

46 When you look at some of the other parts, such as the  
47 quality section, then of course there is an input there for  
48 customers because they have a view on the outcome, and that's  
49 why you see customer groups represented in the quality part of  
50 the industry.

51 **MS REBSTOCK:** Is that the only issue where you think customers have  
52 an interest? Is there a quality dimension?

1 **MR UNDERHILL:** No, I think customers have an interest in quality,  
2 they have an interest in the price they pay and they'd be  
3 interested in the service they get. I think if you got 90% in  
4 those, we'd have a pretty good industry.

5 **MS REBSTOCK:** And you think we can get all of that with no  
6 representation or no voting power from the consumers on the  
7 direction of the industry?

8 **MR UNDERHILL:** I think that the first thing is you need  
9 participation of customers, which is actually now starting to  
10 happen, probably for about the first time, and in the Working  
11 Groups that are -- set out in just about every Working Group  
12 there's customer participation.

13 **MS REBSTOCK:** I think it's interesting that the industry, for the  
14 industry participation and Working Groups and having input into  
15 recommendations that go to the board is not sufficient, the  
16 industry then wants to have voting rights at the end and have  
17 the final say, but for consumers their interests can be  
18 adequately put forward through involvement in Working Groups,  
19 but they don't need to have voting rights, and I find a little  
20 inconsistency on that position. I'd like to hear your comments  
21 on that, given your particular focus on customers.

22 **MR UNDERHILL:** Well, I would go back to the point where those parts  
23 that directly affect customers, there should be opportunity to  
24 participate in the working parties, and in the appropriate  
25 manner I could do not have -- I'm happy for them to participate  
26 in the voting process. I see that, as I said earlier, most  
27 strongly in the missing chapter or the unpopulated chapter  
28 dealing with customer issues.

29 The interesting thing I find with customer issues, there  
30 are the two levels: One is, with a great majority of customers  
31 are who are you and, when we're not sitting in this room,  
32 1.6 million of us; and the other is the major customers, who are  
33 a very organised group of professional people who can make their  
34 case as well as any industry participant. My view is that one  
35 of the critical issues with customers is how you get the fair  
36 representation amongst customers into this process, because  
37 there's a big difference between you and I at home and a major  
38 pulp and paper industry or aluminium smelter, and in my view I  
39 think quite a bit of work is required to establish how you get  
40 the fair input in that before you consider the voting issues  
41 that might come from that, and I think participation of working  
42 parties has shown a significant change in how the industry views  
43 issues, so I'm saying we're taking steps forward in the right  
44 direction. I have no problem at all when resolving those issues  
45 to see voting take place on the relevant issues, but say you  
46 have to take steps through there.

47 **MS REBSTOCK:** You may be aware that the applicant has asked that we  
48 specifically authorise the current voting structure as proposed.

49 **MR UNDERHILL:** I'm aware of that.

50 **MS REBSTOCK:** And it has the potential to lock in the current  
51 proposals before we get this chapter on consumers written in; do  
52 you see any risk in that?

1 **MR UNDERHILL:** Yes I see some risk, but actually I see some risk in  
2 whatever we do. I see some risk if we sit and don't resolve  
3 this and go for another few years working around that. And I  
4 actually see the huge cost to this nation by having taken so  
5 long to get to this point.

6 So what I'm saying is that I think -- in my view this is  
7 the best way forward. I have a whole range of things that I can  
8 bore the Panel with in terms of things that have offended me in  
9 the process, but do I think this will take the industry forward?  
10 The answer is, yes, it does. Will I fight strongly to see that  
11 the customer chapter is filled and the proper input from  
12 customers are? Too right. Because I've been in this industry  
13 to know long enough we have to know we've screwed up in the past  
14 by not taking that input. And, frankly, I don't want another 15  
15 years of doing just the same; unless there is a customer process  
16 it will be just the same.

17 **MR CURTIN:** Just for the sake of argument; we've had one submission  
18 pretty much along the lines of, "Happy to hear from consumers,  
19 but when it comes to voting rights and giving people direct  
20 input on the value of my many hundreds of millions of dollars in  
21 assets, I'm not having a bar of it", and, "Happy to listen, but  
22 when it comes to voting arrangements on assets, this is my  
23 property and, you know, I'll have the final say", and I think  
24 you can recollect who was making that submission.

25 I was thinking earlier about the debate yesterday about the  
26 impact of the under frequency rule change, and we heard some  
27 evidence that arguably hundreds of millions of dollars of assets  
28 could be legacy assets depending on how rule changes went.

29 So, I'm merely laying that out as stuff that's been put in  
30 front of us. So why, in the light of that, would you give  
31 consumers voting rights?

32 **MR UNDERHILL:** Because I think the point that I'm making is, I see  
33 it as a progressive thing. I had a challenge just before as to,  
34 why don't you give it to them now? I see it as a progressive  
35 process because I think there are some real issues in terms of  
36 who is actually voting on behalf of the customers.

37 You know, I've been involved in some debate as to that;  
38 well, you know, I don't think there's going to be a referendum  
39 each time there's a debate as to some security issue or  
40 whatever, but there will be some groups who will say that, we  
41 can represent the customers and some in the supply side of the  
42 industry say, well, we can represent the customers, and maybe  
43 that's true or not --

44 **CHAIR:** I think probably that dimension will emerge as we hear more  
45 submitters over the next two or three days.

46 **MR UNDERHILL:** The point I really want to make is -- what I'm  
47 saying is, I see a progressive move towards that; you asked me  
48 today, do I see that the customer should be part of the voting  
49 process, and I'm saying that I support what's been put forward.  
50 That at this stage, no, sort out how voting would take place,  
51 sort out the chapter that hasn't been filled, look at the  
52 consequences of the other chapters that operate higher up in the

1 industry and the impact on customers, and I'm saying, yeah, that  
2 can happen but let it progressively go through and take the time  
3 to do it properly.

4 **MS BATES:** Could I just put -- Ms Rebstock was pondering the  
5 question of why consumers don't seem to be supporting this  
6 proposal.

7 Well, it isn't encouraging, is it, when the chapter on  
8 consumers has not been written?

9 **MR UNDERHILL:** Yep.

10 **MS BATES:** And whilst you say that you see it as being progressive  
11 stepping up of -- and identifying how properly to represent  
12 consumers, there's no guarantee that other players will have the  
13 same view as you.

14 I'd just like to ask you, why do you think it is that that  
15 chapter wasn't written? I would have thought that the industry  
16 would have wanted the consumers to be on board with this, and  
17 that they would have had a much better show if they disclosed  
18 their hands, but maybe not.

19 **MR UNDERHILL:** No, I've got an easy answer to that. This thing was  
20 to be rolled through in record time, and there were three sets  
21 of industry governance issues dealing with three key areas, and  
22 essentially it was to get the mechanisms in place and the  
23 governance process in place using those existing set of Rules as  
24 a base for that. So, there are many areas, including in those  
25 areas where there's work to be done, and it simply wasn't  
26 addressed.

27 Now, you've got to make a value judgment there.

28 **MS BATES:** I suppose that's the point though, isn't it?

29 **MR UNDERHILL:** Yes, it is, but you asked me why it wasn't in there.

30 In my valued judgment -- and I really think there's an  
31 important role for the customer -- in my valued judgment why I'm  
32 supporting this, and I speak for myself, I think it's important  
33 to get the framework in place in which these things can happen.  
34 And what is interesting to me when you look at the Government  
35 Policy Statement, see how much is related to customers,  
36 sustainability, energy efficiency etc, see how often that is  
37 included in the Rules that you have in front of you and then  
38 say, well, clearly there's several chapters still to be written,  
39 and if that's what the Government Policy Statement says, then  
40 there's going to be considerable incentive to address those.

41 **MS REBSTOCK:** I guess the thing is, it is very clear that the  
42 initial pressure was on to bring these three sets of Rules  
43 together?

44 **MR UNDERHILL:** That's correct.

45 **MS REBSTOCK:** And it wasn't a priority to get the consumer bit  
46 right first; but, nevertheless, the applicant found the time to  
47 put in place a voting arrangement which was not necessary to  
48 bring three sets of Rules together. It wasn't necessary that  
49 that particular voting arrangement came forward.

50 You could have said, "Well, we worked out a fair way that  
51 brings together everyone with an interest here that needs to be

1 represented; we'll give the final decision-making rights to the  
2 independent board", but the applicant has chosen not to do that.

3 So, it did go beyond just bringing the three sets of Rules  
4 together.

5 **MR UNDERHILL:** It did, but I think the trade-off is, it isn't just  
6 that hence the customers were ignored, it is that in each of the  
7 sectors there's a huge agenda of work still being done in each  
8 of those areas, that also was ignored. So what I'm saying is  
9 it's not a customer versus the rest of the industry, there's a  
10 huge set of work to be done.

11 **CHAIR:** Certainly the Commissioners are aware of the Government's  
12 view to get something on the road as quickly as practicable.  
13 The Minister's made a number of statements along those lines, so  
14 I see your point.

15 I guess it's a question of, do you see any role for this  
16 Commission in any determination to give any signals or whatever  
17 into that customer area?

18 **MR UNDERHILL:** Yes, I do. And my view is, and you're making it  
19 sound like I'm responding to your testing question, but I think  
20 one of the key issues facing this new board with the industry  
21 one, or the default was a Government one, is actually how you  
22 put some priority in this. Because in each sector of the  
23 industry, as I said before, there's a huge set of agendas. I  
24 think there's a clear opportunity to say, "Well, our view of the  
25 priorities are this, this and this", and as a framework to do  
26 that I'd go back to the Government Policy Statement and say,  
27 "Let's see what the words say", and use that as an indicator of  
28 perhaps some of the priorities.

29 If I look at those words which I have looked at, I would  
30 say, "There's your customer chapter, there's your sustainability  
31 chapter", which comes in with energy efficiency etc, now that's  
32 got to be some priority to face this industry because the  
33 Government saw fit to put those sort of words into its Policy  
34 Statement.

35 So, a strong "yes" to that question.

36 **MS REBSTOCK:** Have you given some thought to the conditions that  
37 the applicant has suggested might be appropriate should we --  
38 the applicant has framed it in the sense of, should it be  
39 necessary to achieve enough net benefits from the proposal, and  
40 we can debate on whether that qualifier is the only condition  
41 under which we could impose conditions, but what's your view on  
42 conditions?

43 **MR UNDERHILL:** I suppose I came here with -- my primary concern was  
44 prioritisation, and I apologise for not bringing the other  
45 issues through, but that had been such a major challenge, that  
46 if some sense of priority could be given then I think that would  
47 give the best lead forward to this group.

48 The other issue is that one of the things that troubles me  
49 is that it's very easy to get caught up in the process so that  
50 endless work can be dealt with in the process, and I'll use  
51 voting, for example, that you then spend your time on that  
52 rather than getting down to actually things that affect the



1 physical way the system works and the physical delivery and  
2 performance to the final customer.

3 So, one of my concerns, and I'm thinking as I speak, but  
4 one of my concerns is not to get captured by huge bureaucracy in  
5 this process and huge expense, and the sort of figures for the  
6 cost of running this are actually pretty high, and since I said  
7 very strongly my concern about the Government process was the  
8 bureaucracy in there, I certainly don't want to see that  
9 replicated.

10 So, in terms of concerns going forward, how do you minimise  
11 that process, and my view is how you minimise that is, what is  
12 the incentive for this EGB to perform and how are they measured?  
13 I know there's an annual report by the Parliamentary  
14 Commissioner for the Environment etc. I would like to see some  
15 key performance parameters that this industry governance process  
16 is working if you are talking about conditions, to address a  
17 lot of the concerns I see in terms of lack of focus.

18 **CHAIR:** Any other questions you'd like to address to us?

19 **MR UNDERHILL:** No. No, I don't.

20 **CHAIR:** Thank you very much for making the time to come down on  
21 this somewhat windy day, and certainly for your willingness to  
22 respond very directly and forcefully to us, because I think it's  
23 been very useful indeed. Thank you very much.

24 **MR UNDERHILL:** Thank you very much. We apologise for being late.

25 **CHAIR:** All right, well, if I can look at the timetable. Contact  
26 is formally scheduled to start at 3.20, but I wonder if we broke  
27 till about 3.05, could Contact start around about 5 past 3? All  
28 right, we'll do that. So we'll break now until 5 past 3 and  
29 then Contact to the end of the day. Thank you.

30  
31  
32 **Adjournment taken from 2.55 pm to 3.03 pm**

33  
34  
35 \*\*\*

**PRESENTATION BY CONTACT**

1  
2 **CHAIR:** All right, we'll resume. I think Contact, who have been at  
3 the hearing, are aware of the procedures, but just a couple of  
4 points: Four of the Commissioners live from outside this town,  
5 so people may have to leave around 4.15. So the point I'd like  
6 to make is that, if we're not finished I'd like to reschedule --  
7 there is time certainly next Thursday morning, so that we don't  
8 have to cut short Contact's submission or discussion.

9 So, if we don't finish by 4.15, as far as you want to  
10 finish, we can reconvene Contact so the whole hearing can be  
11 heard in front of the full Commission, which I think is very  
12 important, because I don't want parties to feel that they were  
13 cut short.

14 But let's at least start now and see how we get on. One  
15 member has to leave at 4.00, so if that's the case we perhaps  
16 should reschedule a continuation of Contact's submission. In  
17 principle, do you agree with that?

18 **MR STEVENSON:** Gentlemen, thanks very much.

19 **CHAIR:** Can I suggest at least Thursday morning, at least pencil  
20 that in, around 9 o'clock, and if we have to retract anything  
21 that we've said today to keep the argument going, gladly we'll  
22 do it. Anyway, over to you.

23 **MR STEVENSON:** Thank you, Mr Chairman, Members of the Commission.

24 Firstly I'd like to thank you for giving Contact the  
25 opportunity to address the issue of the code, the full industry  
26 code under consideration.

27 Secondly, I'd like to make an apology on behalf of Steve  
28 Barrett, the Contact CEO who is unable to be here with us today.

29 I'd like to introduce the members of the team represented  
30 here on the table. On my left is David Hunt, the General  
31 Manager of Corporate Affairs; myself, Toby Stevenson. I'm the  
32 General Manager of Electricity Trading at Contact; James Kilty,  
33 Legal Counsel, Contact Energy; and Tony Dellow, partner at  
34 Buddle Findlay.

35 David and I were both employed with Contact at the time it  
36 was formally constituted on the 1st of February 1996. You also  
37 need to know, though, that I am the Chairman of the NZEM Rules  
38 Committee. By virtue of that role I'm also on the Electricity  
39 Governance Establishment Committee, who are the applicant, and  
40 one of the roles I fulfilled as part of that committee was I  
41 chaired the Rationalisation Working Group, one of the three  
42 Working Groups that actually put the three existing codes  
43 together under a single title. David was a member of the  
44 Governance Working Group.

45 In terms of addressing issues -- I see my notes say I must  
46 point out, having made the observation that David and I have  
47 worked on a number of Working Groups -- sit on a number of  
48 Working Groups, we are here representing the views of Contact  
49 Energy.

**Contact**

1           The document that the applicant used in the first two days,  
2 the notes for the Conference, one of the recurring themes is  
3 that in every one of the 19 points Contact was in support, and  
4 we would like to give you some context for that support.

5           As an operator in New Zealand we're a large generator,  
6 generating about 25%, and we're a large retailer of the customer  
7 base in New Zealand; some 520,000 customers buy their  
8 electricity from us, and they are distributed from Kaitaia to  
9 the Bluff.

10          We have some 120,000 New Zealand based shareholders who  
11 operate with two and a half billion dollars worth of assets; and  
12 in terms of our assets, our staff, our shareholders and our  
13 customer base, we're distributed throughout the country, but by  
14 virtue of our distribution we're also one of the largest  
15 transporters of electricity in the country.

16          We have supported the formation of the new code subject of  
17 the application because it is an advance on the status quo.  
18 It's an advance on the status quo for a number of reasons, but  
19 when it came time for the application we were asked to indicate  
20 whether we supported the code, the subject of the application  
21 against the counterfactual. We found it very easy -- having  
22 supported the development of the single code, and the processes  
23 by which it was formed, we found it very easy when we then  
24 compared it to the counterfactual indicated in the Draft  
25 Determination, we found it very easy to form the view that the  
26 subject of the application was a better solution to industry  
27 governance than the counterfactual.

28          The principal reason for our support of the rationalised  
29 code over both the status quo and the counterfactual is -- there  
30 are a number of them.

31          The first is that the EGB is comprised of seven independent  
32 parties. No longer do you have the vested interests or the  
33 accusation of vested interests that exist with NZEM, MARIA and  
34 to a lesser extent the GSC.

35          Whether we consider the counterfactual we're concerned that  
36 an introduction of Crown EGB would return to that phenomena  
37 vested interests, and I want to address those as I go through  
38 the points that I wish to make this afternoon.

39          We are fully in support of the single code because it  
40 provides better decision-making than the existing structure, and  
41 in our view it provides a better decision-making platform than  
42 the counterfactual or Crown EGB. The decisions would be made by  
43 people who have the information, people who have the incentives  
44 to make good decisions and the voting is made in the right  
45 balance by the right parties decision by decision.

46          One of the points that the applicant made was that there  
47 was a tension that existed between the -- that would exist  
48 between the new code and its governance structure and  
49 Government, and they made a lot -- there's a lot of detail  
50 written and discussed about the mechanism, but we believe that

1 the tension that exists between the self-governing structure and  
2 the Government, we believe that that tension will be effective  
3 and we are strongly of the view that since December 2000, when  
4 we first saw the Government Policy Statement, that the industry  
5 has made a number of steps in recognition of the fact that there  
6 are a number of things that could be done, and should be done,  
7 and that some people want to be done, and the threat of  
8 regulation has been part of why the steps have been -- why  
9 advancements have been made.

10 **MS REBSTOCK:** Are you going to tell us what those things are?

11 **MR STEVENSON:** Indeed. One of the examples I know of in my role as  
12 the Chair of the Rules Committee was, when a number of issues  
13 were being discussed late in 2001 I put a great deal of effort  
14 in to try to make sure that consumers were represented on  
15 Working Groups. I went to the consumer groups and even though  
16 there was a lot of noise being made publicly, about the winter  
17 of 2001, I worked with the industry participants and Working  
18 Groups, and worked with the consumers and ensured that a number  
19 of issues that were being addressed, such as demand side  
20 participation, real time pricing, that consumers were  
21 represented directly in those, so as that instead of them being  
22 decided by the wrong people or imbalanced people, that consumers  
23 were present.

24 Another example of developments that have occurred since  
25 2001, because they are ideas whose time has come, there is the  
26 Spill Report that David Caygill referred to. Another example is  
27 bids and offers.

28 Can I take a moment to clarify the issue with bids and  
29 offers? You seem to have asked everybody else about it, so I'll  
30 get in early.

31 **MR CURTIN:** We were probably getting ready to ask you too.

32 **MR STEVENSON:** Well, the context in which I raise bids and offers  
33 is that, it's an idea whose time has come and the tension  
34 between the industry wishes and the Government's Government  
35 Policy Statement certainly gave bids and offers some tail wind.  
36 That's the context in which I raise it, but I want to address  
37 the matter as a matter in its own right.

38 Bids and offers have been released since the market began.  
39 Every day we can download the supply curves, we can see all of  
40 the tranches in volume and price. When people talk about the  
41 release of bids and offers sometimes people think that means  
42 that bids and offers are not released; they are, always have  
43 been.

44 What people want released is the identity of who's on the  
45 offer, who's offering generation and the price at which they are  
46 offering it. At the moment I can look and see that there's a  
47 band of 50 megawatts at \$50, always been able to see that. What  
48 you can't see is who is the offerer and the location of the  
49 offerer.

1 I see in some of the submissions that people are using bids  
2 and offers as an example under the status quo of pro-competitive  
3 rule changes being blocked. There was an application to change  
4 the Rules to release the identity of bids and offers the day  
5 after, real time, and that -- I was the person who went to the  
6 Market Surveillance Committee and opposed its introduction. I  
7 argued that identifying the owner of bids and offers the day  
8 after was anti-competitive, and the Market Surveillance  
9 Committee found that to be the case.

10 What's happened now is that --

11 **MS REBSTOCK:** Can you just give us your reasoning on that before  
12 you go on?

13 **MR STEVENSON:** At the moment I make my decisions about my offers  
14 and about the price and quantity of generation based on a pure  
15 supply stack. If the owner of the offer steps were identified  
16 I believe that generators could gang up on a weak generator, or  
17 generators could play other generators as other generators,  
18 rather than economically find the amount of generation in the  
19 price at which they can generate.

20 If you look at other markets, outside of electricity you  
21 are hard pressed to find a market where the owner of the offers  
22 are identified. The broker or a bank or an inter -- you know, a  
23 wholesale trader might be identified but not the owner of the  
24 assets who is making the offer and making the judgments about  
25 the value of their assets. I argued that the release of that  
26 information the day after would jeopardise their ability to make  
27 those decisions freely in that they could be identified and  
28 targeted for anti-competitive behaviour.

29 Now, the proposal has come out in the Government Policy  
30 Statement, which the industry is now working with, is quite a  
31 different proposition from what was voted -- from what was cast  
32 down by the Market Surveillance Committee all those years ago.

33 The proposal now is that the identity of the offerer be  
34 released after one month. The Rules Committee looked at this  
35 and they thought, well -- they got a legal opinion because they  
36 were worried that if releasing the information one day after was  
37 anti-competitive, how many days after could you release it and  
38 it would be pro-competitive?

39 The first Government Policy Statement said that should be  
40 three months, and the second Government Policy Statement said  
41 that should be two weeks. The legal advice that the market was  
42 given -- and this is public information -- was that, if the  
43 information is released less than one month after, it might tip  
44 the balance between being pro-competitive and anti-competitive.  
45 And so, the NZEM Rules Committee has taken that to the vote and  
46 it's been successful, but because there is some momentum behind  
47 having the information released after two weeks rather than  
48 making that decision and risking introducing an anti-competitive  
49 rule change, they're applying to you.

1 **CHAIR:** I think, to ask you your next question would be prejudging  
2 what we might do at that hearing, but I see where you are  
3 getting to.

4 **MR STEVENSON:** No, I was just clarifying the whole issue of bids  
5 and offers.

6 **CHAIR:** It's appreciated very much.

7 **MR STEVENSON:** There's a lot of confusion about bids and offers,  
8 and people say a pro-competitive rule change was cast down all  
9 those years ago and therefore it's all bad, and the Government  
10 has come along and put it in a Government Policy Statement and  
11 we're all responding to that; we're not comparing apples with  
12 apples, but it's an example of where the industry said, "Okay,  
13 this is what they want, we'll do as much as we can", and that is  
14 an example of where the tension between the expressed wishes in  
15 the Government Policy Statement and what the industry is happy  
16 to do.

17 **MS REBSTOCK:** It still begs the question why, all those years ago,  
18 you didn't more quickly come to a proposal that wasn't anti-  
19 competitive?

20 **MR STEVENSON:** I agree.

21 **MS REBSTOCK:** It's taken how many years to move from that point to  
22 this point?

23 **MR STEVENSON:** It does beg the question, and I've often wondered  
24 why nobody ever proposed releasing the data after one month, but  
25 it took till now for somebody to say, "Hey, let's release it  
26 after one month."

27 **MS REBSTOCK:** Well, will we have the same inertia in finding the  
28 way to advance pro-competitive rule changes that was seen in the  
29 past, in the future? Is there anything in the proposal that  
30 suggested that we won't replay that sort of long delay before  
31 we -- the industry finds a way to make pro-competitive rule  
32 changes possible?

33 **MR STEVENSON:** There are two things about that. Firstly, I'm not  
34 aware of any inertia.

35 Secondly, with respect to bids and offers, any person could  
36 have come along at any time and proposed that the bids and  
37 offers be released after one month.

38 **MS REBSTOCK:** Yes, I understand that, but it didn't happen.

39 **MR STEVENSON:** I wonder --

40 **MS REBSTOCK:** And I don't know why it would happen in the future  
41 either, or would it happen?

42 **MR STEVENSON:** If anybody wanted the information, they would have  
43 come and asked for it, and nobody did. But, in terms of the  
44 issue of pro-competitive rule changes globally, what we see is -  
45 - this is the issue about inertia -- what we see is that out of  
46 all of the rule changes proposals that have been taken to market  
47 according to the LECG study, unsurprisingly to me, 27 pro-  
48 competitive rule changes have been passed, virtually all with  
49 about 100% support from generators and retailers.

1           An analysis of the time delay, when you go back over them,  
2 all of the time delay outside of a minimum processing period has  
3 been associated with dealing with the technical, physical and  
4 security issues, and it's my view that the rule changes -- the  
5 pro-competitive rule changes are up-to-date with what is  
6 physically, technically -- and technically possible. I'm not  
7 aware -- I don't see it as an inertia issue.

8 **MR CURTIN:** You may very well come to it, but in your submission  
9 you refer to issues from the system operator which have delayed  
10 pro-competitive developments; such as the introduction of  
11 combined cycle/gas turbine technology.

12           Now, it's not clear to me whether you are just stating  
13 there that these are genuine system security issues or whether  
14 you are bagging Transpower for the delay, pro-competitive  
15 developments. I wonder if you'd just care to, while you're on  
16 the theme of pro-competitive rules being held up or not, whether  
17 you'd just care to amplify on your response to question 9 in  
18 your written submission?

19 **MR STEVENSON:** I am deeply suspicious of recalcitrance on the part  
20 of Transpower, but I'm not here to bag Transpower.

21 **MR CURTIN:** I apologise for putting words in your mouth, this was  
22 just to get the discussion going.

23 **MR STEVENSON:** [pause]. The question 9 that you are referring to  
24 specifically raises the issue of the combined cycle/turbine  
25 technology. Before I address that, I want to address the issue  
26 of Transpower's role in some of the rule changes.

27           As I say, I am not going to opine the degree to which the  
28 delays that they have proposed on a number of rule changes have  
29 been recalcitrance. I know that we should have financial  
30 transmission rights within a year of the market beginning, and I  
31 know that Transpower is only now rushing around doing something  
32 about it, and I know the lack of financial transmission rights  
33 has cost the country tens of millions of dollars.

34           I know that I proposed a rule change in May of 1999 to go  
35 to a five minute ex anti mark, and I know that the delay in  
36 bringing that in has been a series of obstacles placed in its  
37 path by Transpower.

38           I know with respect to demand side participation that any  
39 moves to advance demand side participation have been blocked by  
40 security issues. I can't comment on whether they are real or  
41 whether there is something Transpoweresk about the nature of the  
42 delays.

43 **CHAIR:** Sorry, just to interrupt again, and again in answer to your  
44 question 9, you are really emphasising the same thing, the  
45 degree to which security considerations drive the counter  
46 versus, if you like, innovation and pro-competition.

47           Is there any way of making that judgment, in your  
48 experience?

49 **MR STEVENSON:** Sorry, making the judgment between?

1 **CHAIR:** As to whether the security issue is live or whether, in  
2 fact, it is blocking a pro-competitive element?

3 I mean, under the new structure, do you see the new  
4 structure proposed, the new Rulebook, bringing some solution to  
5 this issue?

6 **MR STEVENSON:** Very much so.

7 One of the things I didn't observe when I was referring to  
8 the quality of the single combined Rulebook against both the  
9 status quo and against the counterfactual, is it would provide  
10 comprehensive coverage and single independent governance for all  
11 matters related to the industry.

12 One of the curiosities, in the last 18 months, as we saw,  
13 the first Government Policy Statement, what has been highlighted  
14 is that there are a whole lot of things that the three existing  
15 codes did not cover; transmission, transmission pricing and  
16 transmission investments is one of those; the whole issue of the  
17 hedge market is another one of those, and without going to the  
18 judgment about the quality of the delays, you've converted that  
19 question into a question of whether or not the proposed code  
20 would give the industry better more timely solutions, and I  
21 would agree with that because it is a single code, because the  
22 votes lie with the right stakeholders, and because it's  
23 comprehensive, I believe, that you will get better more balanced  
24 and more timely decisions.

25 **CHAIR:** Thank you, because I think that's one of the issues the  
26 Commission has to consider pretty seriously when we come to make  
27 a judgment in all this. That seems to be one of the central  
28 issues that was raised yesterday by one of the witnesses for the  
29 applicant as well. Thank you.

30 **MR STEVENSON:** Other things that have been done in recognition of  
31 the tension between the industry and the Government Policy  
32 Statement -- so I've just addressed the fact that there are a  
33 whole lot of things we've identified that weren't covered by  
34 existing codes, and the Spill Rules stand out as an example of  
35 that.

36 Another thing not covered by existing industry codes raised  
37 in the Government Policy Statement, acted on spontaneously by  
38 industry, is work on producing a hedge index being a matrix of  
39 indicative prices of the levels at which hedges have been struck  
40 in the last month.

41 Now, that that work has not seen the light of day yet.  
42 I believe that we'll first see that matrix late in June, perhaps  
43 the middle of July.

44 I mention the fact of consumer representation in the codes,  
45 more consumer representation on the codes. I haven't mentioned  
46 the fact of free-to-air prices. I know that the industry agreed  
47 that, instead of prices and market information solely being made  
48 available through the paid view through the market information  
49 system, it was agreed that certain information would be made  
50 available free-to-air.



1 I think that's a long enough list. I want to turn to  
2 another observation and that is that -- something that Contact  
3 would like to say that hasn't necessarily been said yet. You  
4 see, it's our view that you may have three choices in terms of  
5 this hearing: One is to approve the proposed code; another is  
6 to advocate -- to reject the application and advocate the  
7 counterfactual. We are suspicious there's a third little  
8 discussed option and that would be delaying the -- delaying an  
9 approval or putting in -- in any way putting a process in that  
10 would further delay the introduction of a code, of a single  
11 industry code.

12 While I'm here, one of the things I would like to do is  
13 implore you to come to a clean definitive solution to this  
14 hearing. We are concerned about the hiatus created by  
15 regulation uncertainty. We, Contact, recently announced the  
16 deferral of a very large investment in plant at Auckland. If we  
17 learnt nothing last year, we learnt the fact that the supply  
18 demand balance is a lot tighter than had previously been  
19 thought, the country desperately needs new generation and one of  
20 the reasons we suggested that we were delaying consideration of  
21 that investment was regulation uncertainty.

22 So, I think I've made that point.

23 **MS REBSTOCK:** Can I just -- just one small thing. You indicated  
24 that the second possibility was that we would decline the  
25 application and in so doing be advocating the counterfactual,  
26 and I just want to say that that would not be -- if we were to  
27 decline the application because we didn't find sufficient enough  
28 benefits, we would be simply declining the application on that  
29 basis. We'd be making a comparison with the counterfactual but  
30 we would not be in that case advocating that the counterfactual  
31 should happen, and maybe that's very clear to you, but I just  
32 want to make sure; you indicated as seeing us as advocating that  
33 position should we decline that position. I just want to make  
34 it clear that we would not be doing that.

35 **MR STEVENSON:** I apologise for my unfortunate use of words. My  
36 point still holds that we -- if we need nothing else, we need  
37 certainty.

38 **MS REBSTOCK:** I understand that point.

39 **CHAIR:** I think the other option, and this certainly is only an  
40 option, is an approval with conditional conditions, and that may  
41 or may not be linked to it. It is an option.

42 On that point, will you cover off that question, conditions  
43 as part of your submission anyway, because we did circulate a  
44 proposal from the applicant, so I just want to see whether you  
45 may want to comment on that.

46 **MR STEVENSON:** I don't. There are five issues I want to comment  
47 on, the potential for pro-competitive rule changes to be blocked  
48 by generator retailers; the quality of decision-making under a  
49 Crown EGB and an industry EGB; the potential for over-investment  
50 in the grid under a Crown EGB and under-investment in the grid

1 under an industry EGB; the proposed extensions and also I would  
2 like to address whether the price finding process in the  
3 Rulebook amounts to a breach of Section 30 of the Commerce Act.

4 I understand why everyone is so concerned about the  
5 possibility of pro-competitive rule changes being blocked. I'm  
6 concerned as well. I've never blocked a pro-competitive rule  
7 change. I've already told you that I have blocked one rule  
8 change, and there there's a second that I need to confess to; I  
9 don't believe it was a pro-competitive rule change, but I do  
10 need to confess because people will be very quick to point out  
11 that I blocked another rule change.

12 The first rule change I blocked on the grounds that it was  
13 anti-competitive, and that was the identity of bids and offers,  
14 I've discussed that; the second one I blocked was the NZEM Rules  
15 allow for negative prices to be discovered. Transpower has  
16 never been able to produce the software; that affects that. The  
17 rule should have been taken out of the Rulebook, but in its  
18 place before, one summer there was a hastily cobbled together  
19 and very poor mechanism called a "must run dispatch option"  
20 proposed.

21 I opposed the introduction of the "must run dispatch  
22 option" on the grounds that it did not meet the guiding  
23 principles, it didn't reflect the energy market, still doesn't;  
24 it was supposed to be temporary, it's still with us. The energy  
25 market's based on 48 half hours a day, or based on -- yes, based  
26 on half hours, whereas the must run dispatch auction was based  
27 on two blocks of 18 hours and 16 hours.

28 **MR CURTIN:** Just by way of background, before you go much further,  
29 can you give us a bit of a feel for the practicalities of doing  
30 it later, because we're not from an electrical engineering  
31 background; if you could just give us a feel for what the  
32 problem was and why this was addressed to it in the way it was?

33 **MR STEVENSON:** The Rules envisaged that if demand fell too low and  
34 everyone wanted to run their generators regardless of price,  
35 that they would actually have to pay to run, which is negative  
36 prices because it was not technically possible to produce  
37 negative prices in the software. Or, it was felt that they  
38 should auction the rights to run ahead of those who wouldn't pay  
39 in the auction or who wouldn't participate in the auction. So  
40 what they were selling was, at a cost, the right to run ahead of  
41 others who are not prepared to pay as much, and that reflects  
42 the physical nature of some generation, be it a lot of hydro-  
43 inflows or be it geothermal steam, or whatever the physical  
44 characteristics of the plant were.

45 I opposed the mechanism because I didn't feel that it met  
46 the guiding principles. I felt that in the absence of negative  
47 prices, that negative prices should either be abandoned on -- a  
48 mechanism that met the guiding principles should be introduced  
49 and the work should be done properly and thoroughly.

1 **MR CURTIN:** And why, in your view, did they not meet the guiding  
2 principles?

3 **MR STEVENSON:** I didn't go back through the material in detail, but  
4 the main gist of it was that it didn't mirror -- it didn't  
5 replicate negative prices, it didn't mirror the energy market  
6 that we were operating in. That's the highest level.

7 The Market Surveillance Committee agreed with me -- and if  
8 need be we can get the finding -- they agreed with me that it  
9 did not go all the way to replicating negative prices.

10 **MR CURTIN:** So negative prices would have been a market clearing  
11 price?

12 **MR STEVENSON:** Yes.

13 **MR CURTIN:** I get you.

14 **MR STEVENSON:** But they did find that in the absence of negative  
15 prices it was a step forward therefore the rule was allowed and,  
16 therefore, the must run dispatch auction was introduced.

17 I must say, having had my day in Court, having had the  
18 finding, I have been a user of that mechanism and I've been  
19 happy that the democratic process worked and that everybody had  
20 an opportunity to have a say.

21 **MS REBSTOCK:** Can I just ask you a follow-up question. You've  
22 indicated that you've never voted against pro-competitive rule  
23 change. Have you ever voted for a pro-competitive rule change  
24 that cost Contact Energy some sort of financial loss?

25 **MR STEVENSON:** Sitting here under your gaze, I can't think of an  
26 example -- I can't think of examples. I haven't voted against  
27 any rule changes.

28 **MS REBSTOCK:** I understand that, it's just, you know, we've put  
29 this question to just about everyone and no one can actually  
30 come up with a case where they voted for something that -- you  
31 know, we've had a proposition put to us that this industry is  
32 going to act in the public's interest, even if it costs somebody  
33 something, but we can't find any examples of where that's  
34 actually happened. And so we're still faced with the situation  
35 that it is possible that only rule changes come forward which  
36 benefit just about everyone, and otherwise there's no show in  
37 them coming forward, so I'm just curious. You know, is there an  
38 element of that going on here?

39 We only see pro-competitive rule changes where everyone  
40 benefits and because no one has told me -- nobody has voted down  
41 on pro-competitive rule change, but nobody has ever had to  
42 sacrifice anything for them either, from what I've been able too  
43 discern. It then leaves me with this question, does that tell  
44 me something about what sort of rule changes can emerge under an  
45 industry led process?

46 **MR STEVENSON:** I understand how you might ask the question and  
47 arrive at a position where you would ask the question, but I see  
48 the world a little differently to that.

49 I came here to run a trading function in the electricity  
50 market. I am pro-competition. What I want is, I want the most

1 frictionless environment in which to compete. I don't want the  
2 Rules -- I don't want there to be Rules that in some way  
3 advantage me against my competitors.

4 There are rules, like the fact that I proposed a five  
5 minute ex anti price; that's a rule change that hasn't been  
6 introduced, it's a rule change I actually proposed. There is  
7 analysis that shows that a five minute ex anti price will be bad  
8 for a generator; it may produce outcomes that don't favour a  
9 generator, it may produce outcomes where the facilitation of  
10 more demand side participation now exists.

11 **MS REBSTOCK:** And what's happened to that proposal?

12 **MR STEVENSON:** That proposal has ground its way on and there is a  
13 trial commencing next month of a five minute ex-post price. So,  
14 there won't be a five minute ex anti price in the near term.

15 **MS REBSTOCK:** And why do you think that is?

16 **MR STEVENSON:** Transpower. Transpower didn't want a five minute ex  
17 anti price, they opposed it, and the industry was left with a  
18 choice of five minute ex-post or nothing.

19 **MS REBSTOCK:** Did the generator that was to be disadvantaged by the  
20 proposal?

21 **MR STEVENSON:** I'm sorry?

22 **MS REBSTOCK:** I thought you indicated that one generator would have  
23 been disadvantaged by it.

24 **MR STEVENSON:** I believe all generators had the potential to be  
25 disadvantaged by an ex anti price.

26 **MS REBSTOCK:** Okay.

27 **MR STEVENSON:** But, why would I advocate a rule that had the  
28 potential to disadvantage both me and my competitors? Because,  
29 instead of solving every 30 minutes, by solving every five  
30 months, and particularly solving ex anti, you are going to get a  
31 more frictionless market if it were possible to produce a more  
32 competitive market.

33 **MS REBSTOCK:** And does that benefit you -- leave you with a net  
34 benefit from that?

35 **MR STEVENSON:** Me as a net generator, no. We would all benefit;  
36 New Zealand Inc would benefit from having a more pure market.

37 **CHAIR:** Because there would be more competition -- more price  
38 competition, as simple as that; that's the logic?

39 **MR STEVENSON:** Yes. By definition I'm pro-competitive and that was  
40 an example of a development that people would be pro-  
41 competitive. It's not me against the Rules. I want the Rules  
42 to be frictionless. I'm not competing with the Rules; I'm  
43 competing with other generators and other purchasers in other  
44 locations with other configurations of plant and fuel and staff  
45 and skills, that's who I want to compete with.

46 **MS BATES:** Earlier you said that the country desperately needs new  
47 generation but that your company was delaying making that  
48 decision because of regulatory uncertainty.

49 **MR STEVENSON:** Yes.

1 **MS BATES:** Under what regulatory circumstances would you refrain  
2 from making that investment?

3 **MR STEVENSON:** I'm not going to give you a direct answer to that  
4 question. We're here today to consider the proposal and the  
5 counterfactual.

6 Can I turn to my second issue, which was the issue of  
7 decision-making under a Crown EGB and an industry EGB, because  
8 we would be making a decision for developing our own assets in  
9 the context of a decision-making framework.

10 So, it's not a direct answer to your question, but I want  
11 to raise the issue of decision-making generally under the  
12 proposed governance arrangements for under the counterfactual.  
13 Is that okay?

14 Now, if that doesn't satisfy you that you understand  
15 Contact's perspective then I'd invite you to re-ask the  
16 question.

17 The way we see the proposed industry code, under the  
18 industry EGB the EGB is accountable for the guiding principles  
19 of the new code, and that's the sort of regulatory certainty  
20 that we're used to, we're comfortable and we would like to see  
21 under a rationalised code, with all of the good things that  
22 we've already discussed.

23 We are comfortable under a regime where the Rules are  
24 changed by a vote of appropriate stakeholders. The shift to an  
25 independent governance board and the shift to introduce a more  
26 broader cross-section of voters and more stakeholders in the  
27 votes was the subject of a special Board Meeting that David and  
28 I requested in the middle of last year when the evolution of the  
29 Rules reached a certain point; we took that to the Board and had  
30 some fairly robust debate about it. We'd been supporting the  
31 proposal up until that point we got an endorsement from the  
32 Board and went on to support the proposal which we now see.

33 The regulatory uncertainty for us is the possibility that a  
34 Crown EGB is introduced whereby the Rule change process is quite  
35 different. If I understand the counterfactual correctly, the  
36 Minister would be able to change rules but is obliged to  
37 consider recommendations from the Crown EGB. The Crown EGB are  
38 obliged to consult with stakeholders. The Crown EGB is also  
39 obliged to consult with the Minister.

40 With an industry EGB members are independent and elected by  
41 stakeholders, consumers, networks, generators, retailers, but  
42 under a Crown EGB, if I understand the counterfactual correctly,  
43 the Minister appoints the EGB members. The Minister can dispose  
44 of a member of the Crown EGB at any time entirely at his own  
45 discretion.

46 The other thing that I understand from the Rules is that  
47 even though the Crown changes the Rules based on the  
48 recommendation of the Crown EGB, and the Crown EGB's obliged to  
49 consult with the Minister, we understand that the Minister is  
50 not actually bound to follow the advice of the Crown EGB.

1           So, we are supporting the application, we are supportive of  
2 that as an advance from the status quo, but any dilution of  
3 that, or most particularly the introduction of a Crown  
4 counterfactual -- the counterfactual as represented by the  
5 application -- the very introduction of that would create  
6 regulatory uncertainty and the absence of a confirmation of the  
7 existing code and the casting around for another solution -- be  
8 it a Crown EGB or a yet unknown solution -- both states  
9 represent regulatory uncertainty for us.

10 **MS BATES:** I think I now understand your perspective, thank you  
11 very much.

12 **MR STEVENSON:** Thank you.

13 **MR CURTIN:** Just before we move on, you may have been here for  
14 Professor Hogan's presentation earlier today but, if not; he was  
15 putting forward an argument saying that, for a variety of  
16 reasons, an oversight tier of regulation is required partly  
17 because in his view there is the potential for industry self-  
18 interest to open up a chink between that and national interest,  
19 and that you needed some kind of independent arbiter with some  
20 view of the wider common good sitting on top, and referred in  
21 particular to an arrangement that he called "the PJM  
22 arrangement" in the mid-Atlantic states.

23           What would be your perspective on that line of argument?

24 **MR STEVENSON:** The application contains an independent arbitrator,  
25 what's good for the community as a whole, and it also contains  
26 in it an acceptable tension between the desires of the state and  
27 the benefits of the stakeholders.

28 **MR CURTIN:** What is that arbitrator?

29 **MR STEVENSON:** The independent EGB.

30 **MR CURTIN:** I think the distinction that Professor Hogan was  
31 drawing this morning was that in the PJM market there is an  
32 independent -- let's call it an independent EGB -- with some  
33 executive decision-making powers or override powers. Whereas in  
34 the application as it is in front of us, the Board's role in  
35 decision-making is severely circumscribed.

36           I doubt if Professor Hogan would characterise the Board, as  
37 it is in the Rulebook, as being an arbitrator in your sense.

38 **MR STEVENSON:** To date the record is that, even in the governance  
39 structures with vested interests we have seen pro-competitive  
40 rule changes advanced; we have seen a code developed from a  
41 state of being at the beginning to being more pro-competitive,  
42 and we are seeing an advancement along the same continuum at the  
43 governance level, and I have no reason to think that the  
44 continuum of rules becoming more and more pro-competitive --  
45 there is no evidence that there was to be a backward step on  
46 that continuum.

47           My colleague would like to address the point.

48 **MR HUNT:** One point that I would add to what Toby has said is that  
49 the model that was being advocated by Professor Hogan, I don't  
50 believe, can be compared to the Crown EGB. In particular, FERC

1 is not an elected body; they are appointees, they are somewhat  
2 akin, if you like, to the Governor of the Reserve Bank. They  
3 have some degree of independence, as I understand it, certainly  
4 as we understand it, and here, as Toby was saying, at the end of  
5 the day under a Crown EGB, by virtue of the fact that the  
6 Minister has to be consulted under law, by virtue of the fact  
7 that the Minister doesn't have to follow the recommendation and  
8 that by virtue of the fact that the Minister can appoint and  
9 dismiss at any time for any reason, it's really the Minister  
10 who's in charge. And at the end of the day it's the risks that  
11 are inherent in having an elected official in charge versus an  
12 independent EGB, nonetheless operating under some oversight of  
13 the Government, and it's those two different sets of incentives  
14 is where we see the differences.

15 **MS BATES:** With respect though, it isn't the industry EGB that has  
16 the decision-making power under the proposal, it's the industry  
17 under the voting structure.

18 **MR HUNT:** I think that's correct, although the industry EGB does  
19 have a veto, in effect.

20 **MS BATES:** Yes, but it's the decision-making power, as the  
21 applicant has addressed us on at length actually, and what the  
22 applicant likes about it is, it's with the industry.

23 **MR HUNT:** Yes. As do we.

24 **MR STEVENSON:** Stakeholders, which includes consumers, networks  
25 whatever the appropriate thing --

26 **MS BATES:** Consumers don't have voting rights, of course.

27 **MR HUNT:** That's incorrect. They do in terms of transport  
28 decisions and in terms of common quality decisions, and in terms  
29 of governance arrangements. A third of votes on governance  
30 arrangements are allocated to consumers.

31 **MS BATES:** Thanks. I want to come back to that.

32 **CHAIR:** I wonder if, given the fact that one of the Commissioners  
33 has to leave in a couple of minutes, I'm conscious that your  
34 total presentation is before the full Commission. Is it  
35 appropriate to stop now or can you finish off that, do you  
36 think?

37 **MR STEVENSON:** Mr Chairman, I would like to leave you with some  
38 parting thoughts. We have some examples of poor decision-making  
39 and over-investment, but I also wonder, given the discussions  
40 we've had around Section 30, I was wondering if I could invite  
41 my colleague James Kilty to address that before the Member has  
42 to leave.

43 **CHAIR:** I'm in your hands. But if we reconvened, and I had  
44 Thursday morning in mind, we could then redo the whole thing --  
45 start perhaps, if you like, to finish off the EGB argument, but  
46 subject to your concurrence it would then enable the debate on  
47 the other issues. It would be taken with the full Commission  
48 without cutting you off midstream, that's my concern. I don't  
49 think we'd do you justice if... [pause].

1 **MR STEVENSON:** We'd like to make a statement. We would like to  
2 makes a statement on it. We would like your last thought before  
3 you break-up today to be a statement on Section 30, if that's  
4 okay.

5 **CHAIR:** All right, but you're welcome to come back to it next time  
6 we meet, that's what I'm saying.

7 **MR STEVENSON:** Yes, we might repeat it again, if it's good.

8 **CHAIR:** We have one Commissioner who has to leave, so I don't want  
9 you to feel that the full Commission isn't hearing your  
10 submission, that's the point I'm driving at. Please.

11 **MR KILTY:** At the end of the extended debate with the applicant on  
12 the price fixing issue the final line of questioning from the  
13 Commission was, would a change in the Rules impact on the price?  
14 It is Contact's submission that the Commission cannot and should  
15 not infer from a finding that the wholesale electricity price  
16 would change, or could change, as a result of the change in the  
17 Rules, that Section 30 actually applies to the Rules.

18 I'll just get through our statement and then we can --

19 The question that the Commission in our view needs to  
20 answer is whether the Rules before the Commission, when applied  
21 to the electricity industry in its current form, have the effect  
22 of fixing, controlling or maintaining prices. In our view the  
23 appropriate test to be applied by the Commission is that found  
24 in Decision 280 -- we're having a legal opinion prepared on the  
25 relevance of subsequent caselaw and early next week will make  
26 that available to the Commission and everybody who is  
27 interested.

28 **MS BATES:** I take it you support the applicant's submissions on  
29 Section 30 so far?

30 **MR KILTY:** Yes.

31 In other words, the Commission does not need to consider,  
32 in our view, the effect of the Rules in the context of changes  
33 that may take place in the industry in the future, nor does it  
34 need to be concerned, in our view, about the fact that the Rules  
35 might be changed in the future in a way that means they do not  
36 have -- they do have the effect of fixing, controlling or  
37 maintaining prices.

38 In both cases, because the Commission won't have granted an  
39 authorisation, the Commerce Act will apply and the Commission  
40 will be able to take action to address the effect of the change  
41 at that time.

42 We consider that the issue that needs to be addressed at  
43 this time is the same issue that was addressed by the Commission  
44 in Decision 280, and that issue is whether the Rules before the  
45 Commission are such that if they are applied to the electricity  
46 industry in its current form the prices established under them  
47 would diverge significantly on average from the prices that  
48 might be established without the Rules at this time. If the  
49 answer to that question is no, then Section 30 does not apply in  
50 our view. The Commission, in those circumstances, would have to



1 conclude that it does not have jurisdiction to grant an  
2 authorisation for the Rules.

3 The effect of that view is to put the onus on the EGB  
4 process to ensure that, as circumstances, practical and  
5 technological issues develop in the industry, the Rules also  
6 change to avoid those developments having the effect of fixing,  
7 controlling or maintaining the prices. In essence, the Rules  
8 would have to keep up with the practical advances in the  
9 industry.

10 Perhaps a couple of examples might help, and they are  
11 things that have been referred to by us and other submitters.  
12 The first one is demand side participation.

13 Security issues are currently preventing improvements to  
14 demand side participation in the market. We expect that those  
15 issues will be resolved in time, as the industry develops. At  
16 any time when improved demand side participation is possible, it  
17 will arguably be incumbent on the industry to amend the Rules as  
18 soon as practicable to allow that improved demand side  
19 participation.

20 Any inordinate delay by the industry in doing so will leave  
21 the Rules open to challenge on the basis that, by not allowing  
22 the improvement in demand side participation when it is  
23 technically and practically feasible, they then establish prices  
24 that do diverge significantly from the prices that would be  
25 established without the Rules.

26 Again, because the Commission would not have authorised the  
27 Rules, the Commission will have full powers to investigate and  
28 take action under the Commerce Act in relation to the industry's  
29 tardiness in accommodating the improved demand side  
30 participation.

31 Another example is one that Toby's referred to earlier, and  
32 that's real time pricing or five minute pricing. When it is  
33 proved that real time pricing is in fact technically feasible,  
34 if the Rules are not changed to allow or follow those  
35 technological advances, it could be argued that at that point  
36 the Rules will be caught by Section 30. Changing the Rules to  
37 adapt with the technology to real time pricing would therefore  
38 be required by the industry to ensure that the Rules establish  
39 prices that would be established in the market without the  
40 Rules. As Toby's referred to, there is, I understand it, a  
41 trial beginning in mid-July for that very change.

42 As I noted earlier, and as Toby has pointed out, there has  
43 been some debate on Section 30. We are having an opinion  
44 prepared by Buddle Findlay for the Commission's consideration.  
45 We were informally advised by the Commission that they wished us  
46 to focus on the Chapter G or price setting rules. We therefore  
47 haven't focused on costs allocation and transmission pricing.  
48 If you would like us to add that to our solicitor's brief...

1 **MS BATES:** I think it might be helpful if you do and, if you are  
2 going to produce your opinion and you are going to be appearing  
3 again, it might be helpful if you speak to it.

4 **CHAIR:** I think, if it's possible, those notes you've just spoken  
5 to, and which it seems there may be further notes that you have  
6 spoken to, it would be useful to have those notes before you  
7 appear again so that we're not missing some of the points you  
8 make -- **addressing Mr Stevenson**] -- and, like most things, we'll  
9 circulate them around to the rest of the parties, but I'm  
10 anxious that we don't disconnect between today's hearing and  
11 next week.

12 **MR CURTIN:** Just while we have that as a live issue, we had a  
13 submission from Genesis yesterday as well on this issue of  
14 Section 30, and I just want to get as crystal clear as I can  
15 what your interpretation of the statutory test under Section 30  
16 is for fixing, maintaining and controlling.

17 There are two arguments: One argument is that if you  
18 looked at the price established outside the wholesale spot  
19 market, if the wholesale spot market was not there, and that  
20 price established in some other way was different to the price  
21 established in the wholesale spot market, then the wholesale  
22 spot market could be described as controlling the price for  
23 Section 30 purposes. That's one line of argument.

24 The other line of argument is that you look at the  
25 wholesale spot market as it's operating -- [**Commissioner**  
26 **Rebstock withdraws**] -- you might conclude that there's a free  
27 meeting of demand and supply and there's no interfering of  
28 prices and you would conclude that the market does not infringe  
29 Section 30, and you could argue that what might have happened in  
30 some other stage is irrelevant to the application of that test.  
31 For example, if there wasn't an efficient wholesale spot market  
32 there Contact might have to scratch around to find buyers for  
33 its electricity, and the price that it might or might not find  
34 is quite irrelevant to that earlier test under Section 30.

35 So I just wanted to understand, what is your exact position  
36 on the statutory application? Does either of those views  
37 coincide with your view on -- view on the law?

38 **MR KILTY:** Well, I think to some extent both do. Our view is that  
39 if the Rules do not exist the practical and physical advances in  
40 the market, and assuming the market was competitive, would  
41 produce the same price or the same result.

42 **MR CURTIN:** I understood the point about the trading advances and,  
43 you know, some kind of legacy trading equipment that has been  
44 left behind by technological benefit -- technological change  
45 might actually gradually mutate into something that could be  
46 interpreted as controlling the price, I understand that.

47 But just on the pure legalities -- and I'm no lawyer, which  
48 is why I'm struggling with this -- is your understanding of  
49 Section 30 that that test should be applied irrespective of what  
50 the price might be in another trading arrangement, or should

1 Section 30 be understood only in terms of what the price will be  
2 under an alternative arrangement?

3 **MR DELLOW:** Perhaps it might just help to -- we will show you our  
4 opinion next week, but I guess what we're saying and it agrees  
5 with the other people who have made submissions on these points,  
6 that this term "controlling" has a pejorative connotation, and  
7 that is to say that the prices are controlled in a sense that  
8 they are worse than would happen in a market that didn't have  
9 the Rules, or in the counterfactual, if you like.

10 **MR CURTIN:** Worse or different? Different?

11 **MR DELLOW:** Yes, different, but I think for instance the ACCC and  
12 CC case, when you look at our discussion of that, it's being  
13 held up as being something that just about -- it being  
14 different, but in that case the Judge was finding that the  
15 prices would be higher, and that was a big part of what he based  
16 his decision on; and in our view the decision that was made in  
17 Decision 280 was really saying, there was no evidence to show  
18 that the prices would be different under either of the  
19 scenarios, and that's really where we start from.

20 In the present case before the Commission the question you  
21 have to ask yourself is that, and that would be assuming that  
22 the system is continuing to --

23 **MS BATES:** Excuse me, the question we have to ask ourselves is  
24 what? Could you just repeat that?

25 **MR DELLOW:** The question you have to ask yourself is reflected in  
26 Decision 280, and there the Commission concluded, and I'll just  
27 quote it if you like:

28 "The Commission has seen no evidence that over time the  
29 prices established by the mechanisms would diverge significantly  
30 on average from the prices which might be established without  
31 the mechanisms."

32 **MS BATES:** I understand your submission.

33 **CHAIR:** All right; well, thank you very much. So, with those  
34 requests, that you let us have the opinion when it's available,  
35 and your statement which we'll circulate, if it suits you we'll  
36 start again at 9 o'clock on Thursday morning.

37 **MR STEVENSON:** Thank you.

38 **CHAIR:** Thank you. I think the hearing itself will resume on  
39 Wednesday the 19th, and we are starting at 9 o'clock. So, thank  
40 you very much. Thanks to the transcribers and staff.

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44 **Hearing adjourned at 4.07 pm**

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I N D E X

Presentation by **MIGHTY RIVER POWER**..... 1

Presentation by **TRANSPower**..... 15

Presentation by **WEL NETWORKS**..... 58

Presentation by **CONTACT**..... 74

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