

**APPLICATION BY THE ELECTRICITY GOVERNANCE BOARD
LIMITED FOR AUTHORISATION OF A RESTRICTIVE TRADE
PRACTICE**

**SUBMISSION FROM MERIDIAN ENERGY LIMITED ON THE
COMMERCE COMMISSION'S DRAFT DETERMINATION**

23 May 2002

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- 1 This is a submission by Meridian Energy Limited ("Meridian") on the Commerce Commission's draft determination on the Electricity Governance Board Limited's ("EGBL") application for authorisation of a restrictive trade practice relating to a proposed arrangement in respect of the electricity industry.

- 2 Meridian's submissions relate to:
 - 2.1 the Commerce Commission's assessment concerning the striking down of pro-competitive rule change proposals by major generator-retailers;
 - 2.2 the Commerce Commission's assessment concerning under-investment on the national grid;
 - 2.3 the Commerce Commission's views on regulatory risk and cost of capital;
 - 2.4 Meridian's position concerning Part F (Transport) of the proposed arrangements;
 - 2.5 conditions that might be placed on the Commerce Commission's authorisation; and
 - 2.6 other related matters.

- 3 Meridian's response to the Commission's questions is set out in **Appendix One**.

EXECUTIVE SUMMARY

STRIKE DOWN OF PRO-COMPETITIVE RULE CHANGES

- 4 Meridian disagrees with the Commission's views concerning the risk of generator-retailers voting down pro-competitive rule change proposals.
- 5 The Commission's supposition that generator-retailers have incentives to block pro-competitive rule changes is questionable particularly as the Commission does not appear to have analysed in what areas of the Rulebook this risk might actually arise, and have not made clear what rule changes risk being blocked. This has made it difficult for Meridian to formulate its response.
- 6 On Meridian's analysis, the risk of striking down rule changes:
 - could only arise in respect of Parts A (Governance), G (Trading) and C (Quality and Security), given the voting allocation in these areas and the potential, in theory, to block rule change proposals. However, the risk of this occurring is minimal.
 - is not relevant to Part F (Transport). Generator-retailers as a class do not, in fact, have the ability to block rule changes given the voting allocation in Part F.
- 7 The risk of strike-downs is limited in Parts A, G and C because there are sufficient checks in the self-regulation model to constrain the exercise of blocking powers. The Commission has not given enough weight to the effectiveness of the self-regulation with Ministerial oversight to date. Under the proposed self-regulation model:
 - there will be increased information disclosure to the Minister and to the public on the behaviour of generator-retailers in the market. Any pattern of behaviour in striking down proposed rule changes will be

transparent. Informal information flows to the Minister is already prevalent;

- Ministerial oversight and the threat of regulation are already effective in influencing the behaviour and practices of the major generator-retailers to meet the outcomes of the GPS. Ministerial scrutiny of market behaviour will constrain the exercise of any blocking powers;
- the 3 state-owned generator-retailers are accountable to the Government under the State-owned Enterprises Act 1986. This means that their business behaviour is subject to Parliamentary scrutiny and comment. Again, this is a constraint on the exercise of any blocking powers;
- the independent Board's control of the rule-making process means that the risk of delays will be minimised; and
- generator-retailers have, in reality, acted to reduce barriers to entry and facilitate competitive disciplines to meet the GPS requirements.

8 The risk of strike down is also limited in Part C because of the nature of the rules (i.e. common quality obligations of asset owners). Rule change proposals for Part C are currently specified under a development plan. Generator-retailers have no incentives to block such proposals because:

- the proposed technical rule changes would, if adopted, benefit market participants by reducing costs and improving quality and security; and
- the proposals to introduce market mechanisms for the provision of certain ancillary services would lower the cost payable by generators currently.

9 The Commission's assessment that the exercise of blocking powers would, in the longer term, lead to higher prices, less efficiency and higher

barriers of entry is also misconceived. The Commission has failed to give due weight to the following factors in its assessment:

- rule changes that are likely to occur over time are those which improve market efficiency. The rules in Part G, for example, are process orientated and rules that are likely to be introduced would be those which improve on the present mechanisms. Indeed, the GPS requirements, once developed into rules, would improve the efficiency of the operation of the wholesale market by reducing costs, improving pricing signals and enhancing decision-making. The same could be said for the Part C development options. Therefore, generators do not have any incentive to block such rule changes;
- the rules themselves do not present entry barriers into the generation or retail markets. Generator-retailers have, in reality, supported the development of rules which reduce barriers to entry, for example, by lowering entry fees, providing exemptions from compliance to small generators and adopting technical standards which would enable modern thermal generators to connect to the grid. Examples of such rule changes have been adopted in Parts A, C, G and H. These initiatives lowered barriers to entry and facilitated competition;
- in terms of the structure of the New Zealand electricity market, the ability of new generators to connect to the grid is in the hands of Transpower, not generator-retailers;
- the introduction of new technology is not precluded in the Rulebook. As the GPS requires the industry to move towards the development of renewable energy sources and distributed generation, this is also reflected in the Rulebook. Generators would not have any commercial incentives to prevent the entry of new generation into the generation market if such technology is economic. As generators are already investing in renewable energy sources (e.g. wind), commercial incentives to encourage entry of new technology already exist.

- 10 Given that the Commission's key assumption is wrong on the basis outlined above, it follows that the Commission's assessment of benefits and detriments is also flawed and should be revised.

INVESTMENT IN TRANSMISSION SERVICES

- 11 Generator-retailers have no incentive to vote against transmission investment proposals because:
- the resulting transmission costs would effectively be pass-through costs for generators;
 - investment to remove constraints would enable generators to reduce pricing risk and increase market opportunities;
 - an enhanced transmission infrastructure would assist a generator to mitigate the risk of generator plant failure;
 - the availability of financial transmission rights would encourage investment as they provide generators with the financial equivalent of physical capacity rights over new investment assets and market based indicators of the long term value of transmission constraint and losses rental.
- 12 Distributors have incentives to agree transmission investment which leads to a reduction of energy costs given that periods of higher energy prices might incentivise fuel switching or distribution bypass by consumers.

COST OF CAPITAL

- 13 Meridian disagrees with the Commission's view concerning the impact of regulatory risk on costs of capital on the following grounds:

- the Crown has explicitly stated that it will not guarantee SOE debt or provide financial assistance (for example, the Crown did not provide a financial bail out to Terralink);
- the Crown's position on financial support is reflected in the SOEs' credit ratings, which are comparable to those of privately owned generators, not the sovereign rating;
- regulatory risk would impact the cost of credit of the entire industry. The Crown's ownership of the major generator retailers is not a relevant consideration in terms of assessing the cost of capital.

PART F: DISCRIMINATORY PRICING

14 On the basis of the Commission's view in respect of the perpetuation of existing discriminatory pricing under Part F, Meridian does not reiterate its earlier submissions. However, Meridian remains concerned that the pricing principles in Part F are not aligned with the GPS, in particular for:

- delivered electricity costs (including transmission costs) to be subject to sustained downward pressure; and
- the promotion of out-comes to mirror those in a competitive market.

15 As Transpower has discounted the relevance of these principles in relation to its pricing methodology and the Board is not required to ensure that Transpower's pricing methodology meets the GPS, Meridian invites that Commission require the pricing principles in Part F to be amended so that they include a principle:

- that prices will be non-discriminatory;
- that transmission prices will be subject to sustained downward pressure; and

- that outcomes which mirror those that apply in competitive markets will be promoted.

CONDITIONS ON THE COMMERCE COMMISSION'S AUTHORISATION

- 16 Meridian will not support the imposition of any conditions which will enable consumers to vote on matters affecting the operations or the value of Meridian's assets. If this were to occur, Meridian considers that the counterfactual will be preferable and its position on the proposed arrangements will need to be revisited.
- 17 However, Meridian would be agreeable to the following conditions on the Commerce Commission's authorisation:
- increased information disclosure requirements; and
 - the requirement on distributors to act on behalf of, and consult with, consumers with respect to voting on new transmission investments in Part F, in the same manner as provided for in the draft model distribution agreements.

OTHER RELATED MATTERS

- 18 Meridian notes that EGBL is making submissions concerning the application of section 30 to the pricing mechanism in the wholesale market and supports the view that the Commission should reconsider its assessment of this issue.
- 19 Meridian is very concerned that the proposed arrangements would give rise to barriers to long term investment in New Zealand. Meridian has been considering the relationship between the Rulebook and its bilateral contracts, specifically, its arrangements to supply Comalco's smelter at Tiwai Point. The Rulebook may adversely impact on bilateral contract provisions without consent of the affected parties. Meridian requests that

the Commission notes its concerns and that Meridian may be making further submissions to the Commission on this matter.

SUBMISSIONS

STRIKE-DOWN OF PRO-COMPETITIVE RULE CHANGES

- 20 Meridian notes the Commission's concern that the allocation of voting rights would provide the major generator-retailers collectively with an effective right of veto over changes to substantial parts of the Rulebook, which might prevent pro-competitive rules from being adopted. The Commission considers that generator-retailers would have incentives to exercise such blocking powers¹.

The Commission's key assumption is wrong

- 21 The Commission's assumption is wrong. In particular, the Commission's supposition that generator-retailers have poor incentives and would act to block such rule changes is questionable as the Commission does not appear to have analysed in what areas of the Rulebook this risk might actually arise.
- 22 Meridian has found it difficult to respond to this assumption and to the Commerce Commission's assessment of benefits and detriments without a better understanding of what rule changes the Commission considers might be blocked. Meridian has considered the likelihood of this risk arising in the various parts of the Rulebook.
- 23 On analysis, any risk of striking down rule changes:
- could arise in respect of Parts A (Governance), G (Trading) and C (Quality and Security), given the voting allocation in these areas and the potential, in theory, to block rule change proposals. However, the potential for this to occur is in fact limited. The reasons for this are set out below.

¹ Paragraphs 407, 433-435 of the draft determination

- is not relevant in respect of Part F (Transport). Generator-retailers as a class do not, in fact, have the ability to block rule changes because the voting allocation in Part F means that generator-retailers' votes would be diffused or would require the support of another class in order to 'block'.

PARTS A, G AND C

The strike down risk is limited because the self-regulation model is effective

- 24 The risk of strike-down is limited in Parts A, G and C because there are sufficient checks in the proposed self-regulation model to constrain the exercise of blocking power. The Commission has not given enough weight to effectiveness of the self-regulation model in this regard. Under the proposed arrangements:
- there will be increased information disclosure to the Minister and to the public on the behaviour of generator-retailers in the market. Any pattern of behaviour in striking down proposed rule changes will be transparent;
 - Ministerial oversight and the threat of regulation are already effective in influencing the behaviour and practices of the major generator-retailers to meet the outcomes of the GPS. Ministerial scrutiny of market behaviour will constrain the exercise of any blocking powers;
 - the 3 state-owned generator-retailers are accountable to the Government under the State-owned Enterprises Act 1986. This means that their business behaviour is subject to Parliamentary scrutiny and comment. Again, this is a constraint on the exercise of any blocking powers;
 - the independent Board's control of the rule-making process means that the risk of delays will be minimised; and

- generator-retailers have, in reality, acted to reduce barriers to entry and facilitate competitive disciplines in developing the Rulebook to meet the GPS requirements and this is likely to continue.

25 Each item will be dealt with in turn.

There will be increased information disclosure of industry behaviour

26 Meridian submits that the Commission has given insufficient weight to the extent to which Ministerial intervention and the threat of regulation act as a check against the exercise of blocking power. In particular, under the self-regulatory framework, there will be increased information flows to the public and the Minister on industry behaviour in the market.

The independent Board will be accountable to the Minister

27 It is inherent in the nature of the independent Board that the wider public interest (consumers and new entrants) will be represented in the self-regulation model. Under the current proposal, the establishment of an independent Board is coupled with the Board's accountability to the Minister under the Electricity Amendment Act 2001 ("EAA") in order to ensure that the government's objectives and outcomes under the GPS are met.

The Board's accountability may increase the level of (formal and informal) information disclosure to the Minister

28 The Board's accountability to the Minister under the EAA will result in an increased level of information disclosure to the Minister via formal (annual reports)² and informal channels of communication (ad hoc reports). This, in turn, will increase the level of scrutiny by the Minister of the behaviour and business practices of the major generator-retailers. The practice of providing informal reports is already prevalent and is effective in ensuring that the industry meets the GPS requirements.

² Section 172ZM of the EAA.

The Board has further reporting obligations and review functions under the Rulebook

29 In addition to the annual reporting requirements under the EAA, the Board is required to issue publicly disclosed reports concerning the operation of the proposed arrangements. Details of the behaviour of generator-retailers with regard to rule change proposals will be transparent and any consistent pattern of striking down pro-competitive rule change proposals is likely to be monitored and reported by the independent Board. The Rulebook provides that:

- the Board is required to issue a report which is publicly disclosed on matters concerning the functioning of the rules, including details of proposed rule changes not adopted³;
- the Board is empowered to undertake a review of the rules or any aspect of the electricity industry as it thinks fit and may commission any person to assist it. Indeed, the Board's accountability to the Minister will incentivise the Board to review the development of the proposed arrangements and any pattern of pro-competitive rule strike-downs contrary to the Government's policy. The Board's findings will be made publicly available⁴;
- if the striking down gives rise to an undesirable practice amounting to an *undesirable situation*⁵, the Board can, among other things, notify the

³ Rule 2.2.2 of section II of Part A.

⁴ Rule 2.4 and rule 2.5 of section II of Part A.

⁵ Rule 3.2.2 of section V of Part A.

regulatory authority and comply with any direction by a regulatory authority in respect of that undesirable situation⁶.

Ministerial oversight is effective

30 The Commission has failed to appreciate the extent to which self-regulation with Ministerial oversight is actually working in its assessment. While some parties might argue that the development of pro-competitive rules might have been delayed by industry behaviour in the past, the Commission needs to recognise that the Ministerial oversight of the industry since 2000 has been effective in ensuring progress on the GPS requirements in its assessment. The relevant factors to be taken into consideration can be summarised as follows:

- the Minister can simply amend the GPS to obtain desired outcomes. Indeed, the GPS was revised in February 2002 to take into account the outcome of the Government's review into the 2001 winter crisis⁷. Further, the Ministry of Economic Development ("MED") has recommended a further amendment to the GPS to occur in the near future to take into account concerns regarding the financial transmission rights market and allocation of transmission loss and constraint rentals⁸;
- industry bodies currently report to Minister. Indeed, informal information flows to the Minister concerning the activities of the industry have increased particularly since December 2001. For instance, the Minister has requested the governing bodies of the NZEM and MARIA,

⁶ Rules 3.3 and 3.4 of section V of Part A.

⁷ The revised Government Policy Statement, February 2002.

⁸ See the draft *Financial Rights Summary Statement* in the MED's website:

<http://www.med.govt.nz/ers/electric/fttr/summary.html>

as well as Transpower and the Marketplace Company Limited (“Mco”) to report to him bi-monthly from 31 December 2001 on their progress to implement the objectives of the GPS⁹. Prior to this request, these organisations had in fact volunteered ad hoc reports¹⁰ to the Minister in the absence of regulation. This highlights the industry’s view of the threat of regulation;

- the Minister is concerned about competition issues. In his correspondence, the Minister has indicated that the Government’s key focus is to ensure robust competition in the retail and wholesale markets¹¹. The Minister has met regularly with the Chair of EGEC¹² and has made his expectations to EGEC, NZEM and MARIA clear by seeking and reinforcing the need for completion of measures related to the GPS¹³ as a precaution against the possibility of entering this and subsequent winters with low lake levels. The industry has responded to the Minister’s concerns (see paragraphs 36-40 below);
- the Minister has brought pressure to bear on the industry directly in regard to competition in the retail market and other policy matters.

⁹ See correspondence from the Minister with each organisation in the following website: www.med.govt.nz/ers/electric/gps/implem/index.html

¹⁰ See, for example, letter from the Minister to Mco dated 7 December 2001 acknowledging the Minister’s receipt of ad hoc reports from Mco on progress with work relating to the publication of a hedge price index.

¹¹ See the Minister’s letters to Richard Rowley, Chair, MARIA Governance Board and Toby Stevenson, Chair, Rules Committee of the NZEM respectively, of 12 February 2002.

¹² Post Winter Electricity Review report, Office of the Minister of Energy, paragraph 50.

¹³ Ibid.

Since the 2001 winter crisis, the Minister has called for 3 meetings with the chief executives of the major generator-retailers in December 2001, March and April 2002¹⁴. The industry has responded to the Minister's concerns (see paragraphs 36-40 below).

The state-owned generator-retailers are accountable for their business practices under the SOE Act

- 31 Meridian submits that the risk of blocking powers being exercised is also unlikely given that 3 out of 5 of the major generator-retailers are state-owned enterprises ("SOEs"). The respective Boards of Meridian, Mighty River Power Limited and Genesis Power Limited are accountable to their shareholding Ministers under the State-owned Enterprises Act 1986 ("SOE Act"). As a SOE, the Meridian Board is required to deliver a statement of corporate intent ("SCI"), an annual and a half yearly report to the shareholding Ministers¹⁵ concerning all aspects of its activities including in the wholesale and retail markets and in respect of its involvement in the self-regulatory model. Meridian must table its SCI and annual report before the House of Representatives annually. Its business practices and activities are subject to detailed scrutiny and comment by the Select Committee¹⁶. The report of the Select Committee is publicly available¹⁷.

¹⁴ See, for example, Business Week, *Government Throws Down Gauntlet to Power Companies*, The Dominion December 15 2001; *Minister Calls In Electricity Companies* The Dominion March 5 2002; *Hodgson Deadline for Electricity Giants* The Dominion March 7 2002.

¹⁵ Sections 14-16 of the SOE Act.

¹⁶ See, the 2000/01 *Financial Review of Genesis Power Limited, Meridian Energy Limited and Mighty River Power Limited*, Report of the Commerce Committee, April 2002.

¹⁷ Ibid, see <http://www.clerk.parliament.govt.nz/cgi-bin/search-select?cat=19>

32 Meridian submits that the Commission's assertion that there is a significant risk that the state-owned generator-retailers would act to hinder pro-competitive rule changes is unrealistic. The Commission has not given any weight to the fact that the majority of the generator-retailers are state-owned and are subject to detailed Parliamentary scrutiny.

The independent Board controls the rule-making process

33 Meridian considers that the risk of any delays in adopting pro-competitive rule changes is minimal given that the independent Board implements and controls the rule-making process. The process will not be captured by generator-retailers.

34 The relevant aspects of the rule-making process can be summarised as follows:

- the Board will refer a rule change proposal to a working group for development¹⁸;
- the members of the working group are selected on the basis of expertise and are not representatives of interest groups. The Board will select members of the working group on the basis of their expertise against the selection criteria and which would result in a balance of interest and expertise appropriate to the working groups' terms of reference. The Board is required to have regard to the interests of consumers. Each member of the working group will be selected on a personal basis and not as a representative of the employer or any organisation or interest group¹⁹;

¹⁸ Rule 1.4 of section IV of Part A.

¹⁹ Rule 4 of Schedule A3 of Part A.

- the Board monitors and controls the working group's process. The Board has a discretion to appoint new groups and disband current working groups if the output from the group is not forthcoming or is unjustifiably delayed or the quality of the work produced is objectively unacceptable²⁰.

35 The Commission failed to give any weight to the checks inherent in the rule-making process in its assessment.

Self-regulation is effective

36 Meridian re-iterates that self regulation with Ministerial oversight is effective and has resulted in industry initiatives to implement the GPS. The same incentives will apply to the industry to constrain blocking behaviour. The Commission has failed to give sufficient weight to this factor in its assessment.

37 The effectiveness of the Ministerial backstop is highlighted by the following examples:

- the development by the NZEM of proposals concerning the introduction of rules for increased information disclosure on bids and offers, dispatch prices and initiating a move to implement real time pricing²¹; and
- generator disclosure of hydro spill information²².

²⁰ Rule 5 Schedule A3 of Part A.

²¹ See GPS 15-20.

²² See GPS 5(a) and 16.

- 38 The disclosure of such information is aimed at providing transparency around the behaviour of the market participants (i.e. generator-retailers) as a check against the exercise of market power and to provide for more efficient price signals²³. By providing the demand side with improved accuracy of advance information on likely prices and improving their freedom to respond to the price signals, the level of decision-making by the demand side, particularly in times of tight supply, could be enhanced²⁴.
- 39 Details of industry initiatives are:
- rule changes for the *disclosure of final prices* were adopted on 1 February 2000;
 - the industry has initiated the development of rules for the *publication of bids and offers* four weeks after real time. The rule change will come into force on 29 May 2002 and is a significant advance over the previous GPS requirement for release of generator offer information three months after dispatch²⁵. However, with the revision of the GPS last February, the Minister required the publication of bids and other information two weeks after real time²⁶. The industry responded in

²³ See paragraph 51 of the *Post Winter Review Report*, the Office of the Minister of Energy.

²⁴ See Letter from the Chair of the NZEM Rules Committee to the Minister of 26 March 2002.

²⁵ Ibid.

²⁶ GPS 15.

March by making an application to the Commission for clearance of the two week delay for disclosure²⁷;

- Meridian initiated a proposal in October 2001 for *NZEM bids and offers information* to be released for the period of May and August 2001 for greater transparency around the behaviour of the market participants last winter²⁸;
- the major generator-retailers²⁹ initiated an agreement in July 2001 to *disclose information on hydro spill* to meet the requirements of the GPS. The purpose of such disclosure was to provide greater transparency for the reasons for hydro spill. This agreement was concluded around October 2001. In October 2001, the major generator-retailers proposed that the terms of the hydro spill initiative be included in the Rulebook³⁰. The initiative was accepted by EGEN for further development. In February 2002, EGEN agreed to adopt the hydro spill rules before the rules become operational³¹. Generators are

²⁷ See Rules Committee paper, *Commerce Commission Authorisation – Release of Bids and Offers*, 4 April 2002.

²⁸ See Rules Committee paper, *One-off Release of Bids and Offers Information*, 13 November 2001.

²⁹ Meridian, Genesis Power Limited, Mighty River Power Limited, Contact Energy Limited and Trustpower Limited.

³⁰ See Paper for Electricity Governance Establishment Committee *Consideration of Proposed Hydro Spill Rules*, a report from the RWG, 8 November 2001.

³¹ Letter from EGEN to Keith Turner *Hydro Spill Disclosure Arrangements* dated 21 March 2002.

urged to begin collection of such information for publication in early July³².

- 40 Despite any criticism that the industry has delayed the introduction of such rules since the inception of the NZEM, Meridian submits that these examples highlight the effectiveness of self-regulation with Ministerial oversight. The Commission's supposition that there are poor incentives on generator-retailers is belied by real world behaviour. The Commission needs to give further weight to these factors in its assessment.

PART G

- 41 Meridian notes the Commission's concern that the voting allocation in Part G being in favour of generator-retailers would result in generator-retailers delaying or preventing pro-competitive rule changes. The Commerce Commission suggests that any checks would not necessarily outweigh the commercial advantage which might accrue from vetoing rules which reduce barriers to entry³³.
- 42 The Commission's findings are misconceived for a number of reasons. First, the Commission has undervalued the extent of Ministerial oversight (see above). Second, the Commission's assertion is wrong given the nature of the rules in Part G.
- 43 Part G primarily comprises of rules dealing with market processes concerning for example, bids and offers, calculation of final prices, etc. Meridian submits that the type of rule change proposals that might be adopted over time in Part G are typically those that improve market efficiency in terms of these processes by for example:

³² Ibid.

³³ Paragraph 236 of the draft determination.

- improving the dispatch algorithm; and
 - refining energy and transmission price signals.
- 44 Actual examples to date include the move from the four-hour rule to the two-hour rule and the calculation of day-after final prices as opposed to end-of-month final³⁴ prices.
- 45 Improving such rules increases efficiency in the market and is in the interests of all market participants. Indeed, the GPS requires such development because these rules improve transparency, provide for more efficient price signals and enhance decision-making.

PART C

- 46 In addition to the effectiveness of Ministerial oversight, generators as a class also do not have any incentives to block rule changes in Part C, given the nature of the rules i.e. Part C relates to the obligations of asset owners and the System Operator in maintaining common quality standards in the grid.
- 47 Proposals for future rule changes in Part C are set out in a proposed *Common Quality Development Plan*³⁵. The majority of the technical proposals for development would, if adopted, have the effect of improving efficiency (quality and security) and reducing costs (for example, the proposal for improved modelling of real time reserve requirements would improve security management and reduce costs; the introduction of new load shedding technologies would also improve efficiency and reduce

³⁴ Rule 4, section G of the NZEM rules.

³⁵ See the GSC Report No 135 *Common Quality Development Plan* dated 9 October 2001.

costs). Generators do not have any incentives to block rule changes to Part C because these developments would benefit the operation of the market. The development of these rules is also required by the GPS³⁶.

- 48 Other development options include the evolution of mandated standards towards market arrangements (for example, the development of load shedding and reactive power arrangements). The introduction of market mechanisms for ancillary services would lower the cost of the services as it increases competition. As generator-retailers currently pay a proportion or all of these costs, there are incentives to reduce costs over time.
- 49 In short, any assessment that generator-retailers have incentives to block pro-competitive rule changes in Part C is misconceived.

COMMISSION'S ASSESSMENT OF BENEFITS AND DETRIMENTS

- 50 The Commission has assessed that the use of such blocking powers would, over the longer term, lead to higher prices, less pressure to be efficient, and less incentive to innovate³⁷. The Commission also considers that these long term effects would lead to higher barriers of entry.
- 51 The Commission's assessment is wrong because it also failed to give sufficient weight to the matters below.

Generator-retailers have acted to reduce barriers to entry

- 52 Meridian does not consider that the Rulebook contain rules which would present a barrier to entry. In any case, generator-retailers have acted to reduce any barriers over time. This is illustrated in the table below.

³⁶ GPS 5(l) and (m).

³⁷ Paragraphs 240 and 435 of the draft determination.

Reference	Potential barriers to new generator/purchaser	Industry initiatives to lower barriers
Part A	<ul style="list-style-type: none"> ❑ must agree to be bound to the rules³⁸; ❑ must meet the information requirements from the Board (to be set by the Board); ❑ once admitted as a member, obliged to pay fees³⁹; ❑ participants must meet certain behavioural obligations⁴⁰. 	<ul style="list-style-type: none"> ❑ supported the lowering of fees for entry into the Rulebook. For example, the fixed fees for joining to NZEM is approximately \$75,000, whereas the fixed entry fees for Part A of the Rulebook is \$1,000 and for each other Part, \$500⁴¹.
Part C	<ul style="list-style-type: none"> ❑ must ensure that its assets comply with certain technical requirements to maintain quality of electricity in the grid. 	<ul style="list-style-type: none"> ❑ adopting the <i>de minimis rules</i> under which smaller distributed generators and non dispatchable renewable generators (with capacity below 30 megawatts), e.g. windfarms, are able to connect

³⁸ Rule 8 of section I and Rule 1.5 of section III of Part A.

³⁹ Rule 3 of section I of Part A.

⁴⁰ Rule 8 of section I of Part A.

⁴¹ Rule 2 of Schedule A7 of Part A.

		<p>to the national grid without requiring them to meet the mandated technical specifications. These rules are designed to reduce barriers to entry for smaller players⁴²;</p> <ul style="list-style-type: none"> ❑ adopting new <i>under-frequency standards</i> to enable modern thermal generators (CCGTs) to connect to the grid, thus facilitating the use of modern technology and enabling competition in the generation market⁴³.
Part G	<ul style="list-style-type: none"> ❑ generators and purchasers require the appropriate information systems to meet trading obligations. 	<ul style="list-style-type: none"> ❑ adopted rules for any purchaser or generator to be exempt from full compliance of the trading rules on the grounds of public benefit⁴⁴.
Part H	<ul style="list-style-type: none"> ❑ compliance with prudential requirements are a condition for 	<ul style="list-style-type: none"> ❑ reduced the burden of the prudential requirements by

⁴² Rules 2.1, 2.3 and 2.5 of section 111 of Part C.

⁴³ See paragraphs 38-46 of the GSC's submissions to the Commerce Commission of 1 March 2002.

⁴⁴ Rule 3 of section I of Part G.

	<p>the purchase of electricity and provision of ancillary services under the rules⁴⁵.</p>	<p>agreeing to a NZEM administered scheme to allow hedges to be taken into account in calculating the exposure of market participants⁴⁶.</p>
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- 53 The Commission has failed to take these matters into account in its assessment.

New generator's ability to connect to the grid is not a matter for the Rulebook

- 54 The Commission's view that the long term effect of the exercise of blocking powers would lead to new generators being unable to connect to the grid is misconceived⁴⁷.
- 55 The Rulebook is not relevant to the ability of a generator to connect. New generation can be connected to the national grid provided that the plant meets certain technical connection requirements. These requirements are currently set by Transpower under its connections policy and are not a matter for the Rulebook.

Introduction of new technology is not precluded

- 56 The introduction of new technology in the generation market is not precluded by the Rulebook. The industry is required to move towards the

⁴⁵ Rule 2 of Part H.

⁴⁶ The industry has moved to adopt this proposal following the 2001 winter crisis. This rule change proposal was initiated by Todd Energy Limited on 13 June 2001 and its adoption was made under urgency given the conditions that prevailed last winter.

⁴⁷ Paragraph 435 of the draft determination.

development of renewable energy sources and distributed generated under the GPS⁴⁸. To facilitate these developments, the independent Board is also required to have expertise in these areas under the Rulebook⁴⁹. These factors only serve to foreshadow and encourage the development of new and innovative technology.

- 57 Due to the nature of the common grid, the primary consideration for the introduction of such new generation will be the development of new technical standards to maintain security in the grid. For example, the timing and quantity of generation from wind turbines is uncertain and if the level of generation from windfarms increase significantly, there could be implications in terms of maintaining the quality of electricity in the grid.
- 58 Meridian considers that generator-retailers do not have any incentives to prevent the entry of new generation in the market – if such new technology becomes economic, then the existing market participants will have commercial incentives to invest in such technology and the rules will evolve accordingly. Indeed, Meridian and other generators are already investing in windpower development. The incentives to encourage the entry of new technology already exist.
- 59 The Commission failed to consider this in its assessment.

CONCLUSION

- 60 Given that the Commission's key assumption is wrong on the basis outlined above, it follows that the Commission's assessment of benefits and detriments is also flawed. The Commission's assessment needs to be revised and additional weight be given to the factors above. As the

⁴⁸ See GPS 5(j).

⁴⁹ See Rule 1.4.3 of section II of Part A.

fundamental assumption of the Commission's draft determination is incorrect, Meridian considers that this should have profound implications for the outcome of the assessment of benefits and detriments.

INVESTMENT IN TRANSMISSION SERVICES

61 The Commission has invited comment on its assessment of the impacts on transmission investment in the proposed arrangements relative to the counterfactual⁵⁰. Generator-retailers have no ability to block rule change proposals in Part F relating to new investments, unless, as the Commission has noted, they act with distributors.

Generators have no incentive to under-invest

62 Meridian submits that neither generators-retailers nor distributors have incentives to vote against rule changes concerning transmission investments which would remove constraints (thus maintaining higher nodal prices because retail load is often distant from generation sources). As the Commission pointed out⁵¹, the resulting transmission prices would effectively be passed through to consumers (with the exception of the HVDC link) by way of lines charges in consumers' invoices. For generator-retailers:

- all generators are reliant on transmission to link the source of generation to their loads, so any investment which removes constraints would reduce risk and open up more market opportunities for generators;
- as generation forms an integral part of a generator-retailer's portfolio, any generator failure would result in exposure to nodal prices. Enhanced transmission infrastructure would assist in mitigating plant reliability risks;

⁵⁰ Paragraphs 327 – 332 of the draft determination.

⁵¹ Paragraphs 442 and 443 of the draft determination.

- generators might have further incentives to agree to transmission investment if financial transmission rights are provided in respect of new transmission investments, as investors would be able to obtain the financial equivalent of physical capacity rights over the new assets and obtain market based indicators of the long term value of transmission constraints and losses.

Distributors have no incentive to under-invest

- 63 Meridian agrees with the Commission that distributors are likely to vote in favour of improving the security of supply. However, Meridian disagrees with the Commission's assessment that distributors would gain little from the reduction in energy costs as a result of the transmission investment. Meridian suggests that distributors have the necessary commercial imperatives for reducing constraints as periods of high prices may encourage distribution customers to consider fuel switching and bypass options.

Conclusion

- 64 Meridian considers that this should have implications for the outcome of the assessment of the benefits and deterrents.

COST OF CAPITAL

- 65 Meridian disagrees with the Commission's view concerning the impact of regulatory risk on cost of capital.
- 66 The Commission asserts that a Crown EGB is likely to lead to higher regulatory risk for market participants than an industry EGB. However, the Commission argues that this increase in risk is likely to add 5 to 10 basis points to the cost of capital of *only* the privately owned businesses, Contact and Trustpower, amounting to a detriment from the Crown EGB arrangements of approximately \$11-22 million.
- 67 The Commission explicitly bases its assessment of the risk detriment for a Crown EGB on the assumption that Government owned electricity businesses would not be affected by a more risky regulatory environment. The Commission suggests that this is because these businesses are not likely to be privatised in the near future and investors are likely to view the Crown as guarantor of Government businesses' debts.
- 68 Meridian considers that this assessment is incorrect. The Crown has explicitly stated that it will not guarantee SOE debt or provide financial assistance. A fairly recent example of this can be seen with the fact that the Crown did not bail-out Terralink when it was faced with financial difficulties.
- 69 A review of the credit ratings (Standard & Poor's) confirms that Crown ownership does not mean a credit rating commensurate with that of the Crown. Credit ratings reflect a company's risk profile.

Entity	Credit rating (Standard & Poor's)
Crown	AAA
Meridian	BBB+
Mighty River Power Limited	BBB
Genesis Power Limited	BBB+
Contact Energy Limited	BBB+

- 70 There is a strong body of literature that argues that the value of an asset is a function of its riskiness, rather than the identity of its owner. The Capital Asset Pricing Model ("CAPM") is the original, simplest and most commonly used approach for valuing risky assets. Under the CAPM, the expected return on a risky asset should be equal to the return on a risk-free asset plus a risk premium for the asset in question. A key implication of the CAPM for present purposes is that the expected return on an asset is a function of the risk free rate and the asset's market portfolio (i.e. a portfolio of all traded assets weighted in proportion to their relative market value). It is not a function of the cost of a given investor's funds. The notion that the value of an asset is different from the value that private investors would put on the asset is therefore misguided.

Conclusion

- 71 Meridian supports the view that there would be an increase in regulatory risk for the entire industry. The Crown's position on ownership is not relevant. Meridian considers that this should have implications for the outcome of the assessment of benefits and detriments.

PART F: DISCRIMINATORY PRICING

- 72 Meridian acknowledges the Commission's views in respect of the perpetuation of existing discriminatory pricing as a result of the application of Part F. The Commission has stated that an EGB is required to consider whether or not a proposed pricing methodology is consistent with the Guiding Principles and the GPS and, if Transpower's pricing of the HVDC link distorts new investment, then an EGB would require Transpower to eliminate those distortions⁵².
- 73 On the basis that this is the Commerce Commission's view, Meridian does not reiterate its earlier submissions. However, the Commission should address the issues concerning the pricing principles related to Transpower's pricing methodology.

Part F pricing principles and the GPS are not aligned

- 74 The pricing principles in Part F⁵³ are not fully aligned with the GPS. While the GPS requires:

74.1 that *delivered electricity costs (including transmission costs) are subject to sustained downward pressure*⁵⁴; and

74.2 that *competition is promoted, and where it is not, outcomes that mirror those that would apply in competitive market are promoted*⁵⁵,

the pricing principles in Part F are not subject to these requirements.

⁵² Paragraphs 317 and 318 of the draft determination.

⁵³ See rule 2.3 of section III of Part F.

⁵⁴ GPS 5(d).

⁵⁵ GPS 5(h).

- 75 Both principles are critical. However, as Meridian has noted in its earlier submission, Transpower has concluded⁵⁶ that:
- the principle that delivered electricity costs and prices are subjected to sustained downwards pressure is **not** relevant to its pricing methodology *because forces other than the pricing methodology have a primary influence*;
 - the promotion of enhanced competition is not relevant to its pricing, again because *[f]orces other than the pricing methodology mainly influence this requirement*.
- 76 Under the proposed arrangements, the Board is not empowered to require Transpower to meet the Guiding Principles of the Rulebook or the GPS requirements. Indeed, the Board is only required to assess and confirm if the proposed pricing methodology conforms with the stated pricing principles⁵⁷. There is no requirement on the Board to consider the Guiding Principles of the Rulebook or the GPS.

Amend Part F pricing principles to ensure alignment with GPS

- 77 Given this, Meridian invites the Commission to authorise the proposed arrangements (including Part F) on the condition that the pricing principles are modified so that they include a principle:

77.1 requiring prices to be non-discriminatory;

77.2 that outcomes should mirror those that would apply in a competitive market; and

⁵⁶ In its draft design principles (dated 25 January 2002).

⁵⁷ Rule 5.8 of section III of Part F.

77.3 that transmission prices are to be subject to a sustained downward pressure.

A proposed amendment to Part F is **attached** in Appendix Three.

CONDITIONS ON THE COMMERCE COMMISSION'S APPROVAL

78 Meridian is prepared to consider limited conditions on the Commission's authorisation. However, Meridian will not support the imposition of any conditions in the proposed arrangements which would enable consumers to vote on matters affecting the operations of Meridian's assets and which impacts on the value of such assets (i.e. Part G). As noted previously, Meridian disagrees with the Commission's assertion concerning implications of the voting allocation with regard to Part G. If consumers were to be given the right to influence the operations of Meridian's assets, Meridian considers that the counterfactual would be preferable and its position on the proposed arrangements would need to be revisited.

79 Meridian would be agreeable to the following conditions being imposed on the Commerce Commission's authorisation:

79.1 increased information disclosure requirements; and

79.2 the requirement on distributors to act on behalf of, and consult with, consumers with respect to voting on new transmission investment in Part F. Meridian suggests that a way of managing the Commission's concerns relating to any votes by the industry (or rather, the distributors) against transmission investments would be to provide for a formal mechanism through which distributors act as a proxy for consumer interests in relation to transmission investment. The draft model distribution agreement already provides for this sort of consultation.

OTHER RELATED MATTERS

Application of section 30 to wholesale market pricing mechanism

- 80 Meridian notes that EGBL is making submissions concerning the application of section 30 to the pricing mechanism in the wholesale market and supports the view that the Commission should reconsider its assessment in this regard.

Barrier to investment

- 81 Meridian has been considering the relationship between the Rulebook and its existing contractual arrangements specifically its arrangements to supply Comalco's smelter at Tiwai Point. In doing this, Meridian has become concerned that the Rulebook may automatically amend these bilateral arrangements without consent of the affected parties. This has serious implications for Meridian and future investors in New Zealand. Meridian doubts that investors will take comfort in investing in an environment where other third parties' interest may result in decisions being made around shared services that run counter to the investors' long term commercial interests.
- 82 Meridian **attaches** as Appendix Two a letter signed by Meridian, Comalco and Transpower expressing concerns on this issue. Meridian would like to reserve its right to make further submissions on this matter

APPENDIX ONE

RESPONSE TO THE COMMISSION'S QUESTIONS

- 1 Meridian's response to the following questions are set out below.

Question Reference	Meridian's Response
Q2 (Market definition)	Yes
Q3 (Application of section 30 to wholesale pricing mechanism)	Meridian refers to EGBL's and the NZEM Rule Committee's submissions and support the view that the wholesale pricing mechanism does not breach section 30.
Q7 (Counter-factual)	Meridian accepts the Commission's counter-factual, subject to its views concerning the need for amendments around Part F.
Q9 (Strike down of pro-competitive rule changes)	No. Please refer to Meridian's submissions in paragraphs 20-60
Q10 (Strike down)	Please refer to Meridian's submissions in paragraphs 20-60
Q12 (Implementation of pro-competitive rule changes under NZEM, MACQS and MARIA)	Please refer to Meridian submissions under paragraphs 36-40; 52-53.

<p>Q13 (Proposed rule changes to enhance competition)</p>	<p>Meridian considers that work is under way in order to meet the GPS requirements which would enhance competition. Additionally, Meridian is supportive of rules which would increase information disclosure in order to enhance transparency.</p>
<p>Q15 (Competitive services under Crown EGB)</p>	<p>Meridian considers that the implementation of a Crown EGB will lead to less competitive outcomes in the provision of services compared to an industry EGB.</p>
<p>Q17 (Would Part C lessen competition compared to the counter-factual)</p>	<p>Meridian's view is that provisions of Part C do not lessen competition compared to the counter-factual. Please refer to Meridian's views in paragraphs 20-40; 46-60.</p>
<p>Q20 (Differences between an industry EGB and a Crown EGB to assess pricing methodologies)</p>	<p>In relation to the assessment of transmission pricing methodology, the Crown EGB would implement the GPS, including the requirement for transmission pricing to be subject to downward pressure and to mirror competitive market outcomes. Under the proposed arrangements, the industry EGB is not subject to these wider principles – please refer to Meridian's submissions in paragraphs 72-76.</p>

Q23 (Impact on transmission investment)	Please refer to Meridian's submissions in paragraphs 61-63.
Q24 (Assessment of transmission pricing methodology between either governance arrangements)	Please refer to Meridian's submissions in paragraphs 71-76.
Q25 (Would the provisions of Part G lessen competition compared to the counter-factual)	No. The provisions of Part G will evolve to meet the GPS requirements which would enhance efficiency and competition – please refer to Meridian submissions in paragraphs 20-45; 50-60.
Q23 (Cost of capital)	Meridian considers that the Commission's views on the cost of capital is wrong – please refer to Meridian submissions in paragraphs 64-70.
Q43 (Scope to remove or lower entry barriers or improve efficiency)	Please refer to Meridian's submissions on the strike down issue.
Q44 (Do distributors' have incentives to vote to reduce or eliminate grid constraints?)	Meridian considers that distributors have incentives to reduce or eliminate grid constraints – see paragraph 63.
Q45 (Do distributors have different attitudes towards constraints that have security implications versus transmission)	No. See Meridian submissions in paragraph 63.

constraints leading to higher energy prices)	
Q49 (Conditions on authorisation)	See Meridian submissions in paragraphs 77-78.
Q51 (Other matters concerning conditions)	Yes. Meridian will not accept any conditions which would affect the value or operation of its assets – see paragraph 77.
Q62 (Likelihood of under-investment under the proposed arrangements)	No. Meridian considers that neither generators nor distributors would have incentives to under-invest – see paragraphs 62-63.

APPENDIX TWO

COPY OF LETTER TO EGEN

22 May 2002

Hon. David Caygill
Chairman
Electricity Governance Establishment Committee
c/- PO Box 5422
WELLINGTON

Dear David

A common issue exists, which we believe is serious and will prevent Meridian Energy, Comalco and Transpower from joining the proposed new arrangements.

In essence this problem relates to the interface between our existing long term arrangements at Tiwai Point, as well as the ability for future investors to gain certainty on long term commercial positions with regards electricity supply.

Investors may choose not to invest in New Zealand because of concerns that, under the rulebook, other parties' commercial interests may result in decisions being made around shared services that run counter to the long term commercial interests of the investors. Our concern is that as commercial enterprises we will not subordinate commercial interests in this way. It is likely that other investors will share this concern and may choose to locate overseas.

Turning to our existing arrangements we all have concerns that the rulebook as it stands may, at a minimum, automatically amend our contracts. These contracts are longstanding and have many years to run. The potential for future changes to the rules, which are outside our control, are not subject to a net national benefit test, and have significant adverse impact on our existing bilateral arrangements, is clearly unacceptable.

These concerns will need to be addressed in such a way as to satisfy all three parties, otherwise it is inevitable that there will not be sufficient commitment to enable the arrangements to go ahead.

These issues need to be addressed as a matter of urgency.

Yours sincerely

Kerry Macdonald
Executive Director
Comalco New Zealand

Peter Robertson
Acting Chief Executive
Transpower New
Zealand

Keith Turner
Chief Executive
Meridian Energy

cc: Hon. Pete Hodgson, Minister of Energy
John Belgrave, Commerce Commission

APPENDIX THREE

PROPOSED AMENDMENT TO PART F

Rule 2.3.2 of section III of Part F will be amended by adding the following words to the end of that rule:

“2.3.2.6 Non-discriminatory

Is non-discriminatory;

2.3.2.7 Promote competitive outcomes

Promotes enhanced competition wherever possible, and, where it is not, seek outcomes that mirror as far as possible those which would apply in competitive markets;

2.3.2.8 Downward pressure on price

Ensures that transmission prices are subject to sustained downward pressure.”