SUBMISSION
BY TRANSPOWER NEW ZEALAND LIMITED

on

THE APPLICATION FOR AUTHORISATION OF THE RULEBOOK

Executive Summary

Transpower New Zealand Limited ("Transpower") considers that the Rulebook will lessen competition in the relevant electricity markets compared to the counterfactual of a Crown EGB. Transpower agrees with the Commerce Commission's preliminary conclusion that the benefits of the proposed arrangement do not outweigh the detriments.

Transpower considers that the single most significant factor in assessing the impact of the Rulebook is the fact that it is industry participants who will have ultimate control of the Rules. The role of the Industry EGB established under the Rulebook is primarily one of acting as a process manager for industry rule making, with only very limited decision-making powers. Transpower believes this to be a departure from the GPS. The GPS envisages an EGB independent of the industry which will be held accountable for rules delivering on the outcomes specified in the GPS.

The Applicant's position is based on the assumption that the commercial incentives of industry participants will naturally result in efficient and pro-competitive outcomes. Transpower agrees with the Commission that "individual participants would vote in their own self-interest, which may not always be in the interests of overall efficiency".

Transpower considers this lack of commonality between industry interests and efficient/pro-competitive outcomes will be a frequent occurrence under the Rulebook, and the effect of commercial incentives combined with the limited effectiveness of any constraints on industry decision-makers will result in significant anti-competitive changes and lack of pro-competitive development.

Industry participants cannot be expected to ignore their commercial imperatives where these conflict with competitive outcomes. Professor Hogan's account of international experience concludes that market participants cannot be relied upon to create a framework of efficient rules and incentives. There is a need for a regulator with authority to make decisions that are in the wider public interest, even if these decisions are not supported by a majority of the market participants. This is essentially what would occur under the Crown EGB. Importantly, however, the Crown EGB will be able to act with full knowledge of the views of the industry and not, as has been suggested, in isolation or ignorance.

Transpower also wishes to draw the Commission's attention to the following points in summary of its position:

- there is a real risk that one or more industry participants will not join the Rulebook, resulting in both physical consequences (such as loss of supply to end consumers) and in costs and uncertainty associated with attempts to enforce Rulebook services (or at least the payment for those services) through quantum meruit;

- the incentives to act in industry participants' commercial interests and the opportunities to use the Rulebook and its processes to promote those incentives is likely to result in anti-competitive rules. The constraints identified by the Commission in the Draft Determination are weak and are unlikely to be effective in preventing such anti-competitive rules;

- those same incentives are also likely to result in the industry failing to develop pro-competitive rules. The Rulebook processes will not facilitate pro-competitive rule changes where those do not align with the majority commercial interests. Without a specialist regulator with authority to promote pro-competitive development it is unlikely to occur;

- Transpower disagrees with the Commission's suggestion that industry decision-making under the Rulebook will be superior to the Crown EGB. This assumption does not take into account how the industry's incentives will distort decision-making. In contrast the Crown EGB will be a specialist and expert entity driven by, and accountable for, the objectives set under the Electricity Amendment Act 2001, but still able to access industry knowledge and be responsive to the concerns of industry participants. This is likely to result in more efficient and pro-competitive decisions; and

- the risk of over-investment under a Crown EGB is extremely low due to the constraints on both the Crown EGB and the transmission provider against over-investment. In contrast, the risk of under-investment under the Rulebook is very high. There is no effective body accountable for ensuring necessary investment occurs in the absence of industry agreement.

Transpower has obtained expert economic analysis from both NZIER and Professor Hogan of Harvard University and LECG. Separate submissions will be filed by each of them and their advice is referred to in this submission.

Introduction

1. This submission responds to the issues raised in the Commission's Draft Determination on the Electricity Governance Board Limited's application for authorisation to enter into an arrangement and give effect to various provisions of a Rulebook that determine the way that the electricity industry trades electricity.

2. Transpower's submission is organised around the following key points and issues:

   (a) the scope of the authorisation;

   (b) the mandatory/voluntary issue;

   (c) the existence and development of anti-competitive rules;

   (d) the lack of development of pro-competitive rules;

   (e) decision-making;

   (f) transmission investment;

   (g) contestability of service provision;

   (h) international experience; and

   (i) conditions.

3. In response to the Commission's specific questions, Transpower's answers are summarised in Appendix 1 either directly or, where appropriate, by reference back to the main text or to the expert submission prepared by NZIER.

Scope of Authorisation

4. The Applicant has attempted to clarify the scope of the application by reference to specific provisions which it has broken down into seven separate categories. Some of the provisions for which the Applicant has claimed authorisation do not relate to their alleged justification. For example, the Applicant has claimed that transitional dispensations is one of the comprehensive coverage provisions. Transitional dispensations do not themselves need to be mandatory. The competition analysis of the transitional dispensation regime is quite different to that required for other provisions specified in the same category e.g. the quantum meruit provisions.

5. Even where the provisions within a category have a common competition rationale, the competition analysis cannot be carried out in isolation from other provisions of the Rulebook, in particular the over-arching influence of the governance provisions. It is therefore difficult to understand on what grounds the Commission could authorise the specific provisions identified by the Applicant while not addressing the need for authorisation of other provisions that clearly raise competition concerns.

6. Transpower considers that the Commission needs to either:

(a) consider the specific provisions the Applicant has identified and whether there are any other specific provisions (such as those relating to governance) that need to be included in order to carry out a coherent competition analysis and on the basis of analysis of such provisions decide whether or not to authorise them; or

(b) reject the Applicant's attempt to isolate specific provisions on the grounds that the Rulebook is too interlinked to enable such isolation and expressly analyse, and decide whether or not to authorise, the whole Rulebook.

The Draft Determination focuses on the entire Rulebook and does not draw distinctions between provisions for which authorisation is being sought and those for which it is not. The issues on which the Commission expresses significant concern – in particular the allocation of voting rights – are not within the specified provisions identified by the Applicant.[1] This suggests that the Commission has in reality adopted the approach set out in (b) above, but has not done so expressly.

7. This approach raises significant issues for an authorisation, if granted, and will if not resolved, create endless problems for the industry in trying to determine what is or is not within its scope. This is not only undesirable from a policy perspective but has real transactional costs that need to be factored into the cost/benefit analysis. If an authorisation is granted, the boundaries of that authorisation must be clearly defined.

Counterfactual

8. Transpower agrees with the counterfactual set out in the Draft Determination consisting of a Crown EGB established by regulation, with final decision-making authority resting with the Minister. Transpower's comments relate to the extent and impact of the differences between an Industry EGB and a Crown EGB on the specifics of the Rules in relation to governance and voting (initially) and the development of rules (in future). These differences are likely to result in a substantial lessening of competition. Transpower believes that it is most helpful to the Commission's examination of the arrangement to address the competitive impact of those differences in relation to the specific issues below.

The Mandatory/Voluntary Issue

9. Transpower welcomes the Commission's recognition of the need for the "common application of security, dispatch and reconciliation provisions",[2] but in Transpower's view, the Commission does not adequately distinguish between the Rulebook's and the counterfactual's ability to impose mandatory provisions on all industry participants. The statement in the Draft Determination that "there would be requirements in both the proposal and the counterfactual which make these provisions mandatory to all" assumes that each governance regime has an equivalent ability to impose such provisions on all industry participants. This is

[1] Voting arrangements are set out in Part A: Schedules A5 and A6. These schedules are not listed in Russell McVeagh's letter to the Commission clarifying the Application, dated 5 February 2002, as either primary or secondary provisions for which the Applicant seeks authorisation.

[2] Paragraph 257. All paragraph references are to paragraphs in the Draft Determination unless otherwise specified.

not the case. The Rulebook is by definition a voluntary arrangement and so cannot bind parties who elect not to join it. Instead it is reliant on incentives to coax compliance (or "comprehensive coverage" as the Applicant terms it).

10. To the extent that the "incentives" to join take the form of restricting the supply of services to non-members by members, Transpower believes they are likely to be exclusionary in breach of section 29 of the Commerce Act 1986. The Applicant depends on the s29(1A) provision that provides a defence where it can be proved that an arrangement that would otherwise be exclusionary does not have the purpose or the effect or likely effect of substantially lessening competition. However, the Applicant has not established that the relevant provisions restricting supply to non-members do not substantially lessen competition.

11. If the incentives for comprehensive coverage of the Rulebook: (a) fail to result in everyone joining and/or (b) involve a cost in attempting enforcement, there will be a significant detriment compared to the counterfactual. This detriment has not been addressed in the Draft Determination but must be included in the quantification of benefits and detriments.

12. There are two main costs that arise from the lack of mandatory coverage of the Rulebook. These are:

(a) the costs of non-members not complying with mandatory elements such as common quality requirements and new investment; and

(b) the cost of pursuing a quantum meruit case to attempt enforcement of the provisions of the Rulebook on non-members.

Non-Members

13. Transpower has serious doubts about the statement in the Draft Determination that "in practice there will be few, if any non-members…"[3] under the Rulebook. Transpower is not aware of any evidence for this conclusion. Industry participants have not yet had to commit to a position on whether or not to join the Rulebook but many have already indicated opposition to the Rulebook's provisions. Transpower, for example, has publicly stated that it will consider not joining the Rulebook in its current form[4] and it believes it is likely that one or more other industry players will not join. For example, Comalco has indicated that it would not be bound by the proposal were it to be authorised.[5] ENA has indicated that it is relying on its members being able to "opt not to become participants, or to withdraw from the arrangement."[6] Similarly, there can be no certainty that new entrants would wish to join the arrangements. Therefore, there is clearly a real risk, with a non-mandatory arrangement, that not all industry participants will join the Rulebook. This is one of the fears expressed by several industry participants in their submissions, including a number that otherwise support the Rulebook.[7]

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3 Paragraph 264.
4 Transpower's presentation to the Commerce Committee, 14 February 2002.
5 Comalco "Submission - Authorisation Application for Electricity Governance Board Limited", 22 February 2002.
6 Electricity Networks Association Submission, 28 February 2002 at paragraph 9.
7 See for example the submissions of Genesis Power Limited and Mighty River Power.

14. Even if the Commission is correct and there are only a "few" non-members, this is not the same as having no non-members (i.e. everyone joining). There will be costs associated with even a single industry participant failing to join the Rulebook. These costs include the following:

(a) increased costs and risks incurred in ensuring that security and quality of the power system is maintained. For example, to accommodate the risk of non-compliant behaviour by non-members, additional stand-by reserves would need to be incorporated in arranging dispatch. This would result in a less efficient dispatch with the likelihood of a higher market clearing price (and increased nodal prices). In an extreme case, the result of non-compliance will result not only in increased costs from dispatch but also increased risk to security and quality of supply through reduced contingent security levels. If a contingent security event occurs, there is an increased probability of demand being unserved;

(b) an increased risk of under-investment in transmission. Part F of the Rulebook, relies on full membership to operate successfully.[8] For example, Part F provides mechanisms for ensuring that transmission investment can take place where there is majority support by transmission purchasers for an investment. If there are transmission purchasers that are not bound by the Rulebook, there is scope for those parties to free-ride on any investment (which may itself incentivise non-membership). With an interconnected grid, a non-member cannot be excluded from receiving the benefits of a new investment but, as a non-member, cannot be argued to have agreed to the investment and thus be expected to pay a share of the costs of the new investment.[9] This is likely to result in under-investment; and

(c) an increased risk of non-payment of transmission charges and common quality charges. The difficulty Transpower faces in recovering transmission charges under the existing (non-mandatory) industry arrangements has been recognised by Government and ameliorated on an interim basis through legislative amendment.[10] Upon expiry of the transitional period Transpower would have no guaranteed ability to recover transmission charges from non-members.

15. The likelihood of these costs arising is not mere supposition but can be backed up with evidence of the costs associated with industry participants that currently refuse to sign transmission or new investment contracts with Transpower.[11] There has been a history of problems under the current arrangements with the enforcement of both common quality standards and sunk cost/new investment charges. The Kiwi Co-generation Joint Venture's refusal to sign a connection contract in respect of its generation plant at Hawera is a salient example of the

8 There are other risks of under-investment inherent in Part F. These are dealt with in the section entitled "Transmission Investment" below.

9 Any attempt to recover the cost of the non-member's share of the investment through quantum meruit would be difficult to argue if the non-member had expressly rejected the service.

10 Section 19 of the Electricity Amendment Act 2001 ("EAA"). This provides transitional support for Transpower's current methodology for grid connection charges (it does not cover common quality charges and non-payment of these charges by customers). The interim nature of this legislation is based on the expectation expressed in the GPS that the industry arrangements would deliver effective mandatory membership and enforceable transmission charges.

11 These contracts are the existing mechanism which attempts to enforce compliance with "mandatory" provisions such as security, dispatch and reconciliation.

effect that one party's refusal to accept the application of common quality standards can have on system security and the quality of supply received by end-use customers. Despite ongoing discussions with Transpower, the Kiwi Co-gen plant does not comply with Transpower's Common Quality Obligations ("CQO") in respect of voltage control systems.[12]

16. The consequences of the lack of a compliant voltage control system were highlighted on 8 June 2001 when problems arose at Hawera in relation to a planned outage on the Hawera-Stratford circuit. The Kiwi Co-gen plant's inability to control voltage in accordance with the CQO led to extremely high voltages and voltage fluctuations. The necessary planned outage had to be cancelled to avoid danger to plant and personnel, and potential loss of supply at Hawera. Following this incident complaints were received from other connected parties at Hawera. As a consequence of the Kiwi Co-gen plant's inability to automatically respond to changing system conditions, the System Operator has had to adopt unusual measures to help manage the risk to the system posed by the Kiwi Co-gen plant. These measures could result in the total loss of supply to load at Hawera, including Fonterra's dairy factory at Hawera.[13] This shows that even a small player's non-compliance can have a significant impact on the wider economy.

17. Transpower has identified measures which could be taken by Kiwi Co-gen to install a control system to bring the generation plant into compliance with the CQO and remove the risk to supply at Hawera but has been advised by Kiwi that its joint venture partner Todd is unwilling to install the control system. This example illustrates the effect on consumers' quality of supply which one party's refusal to be bound by common quality standards can have. The length of time the non-compliance has remained unremedied also demonstrates the impracticality of seeking to enforce common quality standards in the absence of contract or mandatory governance.

Enforcement through Quantum Meruit

18. As well as the immediate physical consequences and costs of non-members, there will be a cost associated with the attempt to enforce non-members to pay for services supplied by members through the mechanism of quantum meruit. Obviously these enforcement costs do not arise under the counterfactual as there will be no equivalent of "non-members", so all these costs must be incorporated into the quantification of detriments. The Draft Determination does not reflect these costs.

19. To establish this cost, one could start with looking at the cost of a single quantum meruit case. It is reasonable to assume that the direct cost of running a quantum meruit case in the High Court is in the region of $1 million, with the cost of taking an appeal being additional. (This does not include indirect costs such as the cost of the court process.) Such a cost should be regarded as the bottom of the range of detriments as a single quantum meruit case may not resolve non-payment issues. It is more than likely that several test cases will be required to establish all the relevant legal principles. One reason for this is that quantum meruit may be an appropriate method of settling one-off disputes where the value of the service is

[12] Equivalent provisions are set out in the Rulebook at Part C: Section III: Rule 3.2, and Technical Codes: Schedule C3: Rule 5.2.1.

[13] Previously owned by Kiwi Co-op Dairies and now a Fonterra company.

easily quantifiable by reference to some objective equivalent, but this is not the case here where the valuing of services is complex and not easily referenced and may change over time. The likelihood of multiple cases will result in a period of uncertainty for at least 2-3 years during which the industry will be unsure whether prices charged are reasonable and whether fees will be fully recoverable.

20. The Applicant appears to consider that even if there were initially non-members, a quantum meruit case would solve the issue and result in full coverage within a short period. This is unlikely to be the case. There is no guarantee that quantum meruit will act as an effective incentive for other non-members to join, as it is not enforceable except as between the parties to the action. Furthermore, quantum meruit does not address disputes regarding non-pricing issues, (for instance it cannot be used to enforce the common quality requirements for equipment connected to the electricity system) and even in respect of pricing issues it is not suited to solving multi-lateral or ongoing disputes.

21. There is a possibility that a quantum meruit action would fail – particularly given the uncertainties of its application to the situation of non-members and specifically whether or not non-members can be said to have received a service (especially if they have attempted to expressly reject that service). If a quantum meruit action did fail it is likely to signal the failure of the Rulebook and its subsequent replacement by a Crown EGB. The costs of this possibility need to be counted.

"Comprehensive Coverage"

22. The notion of "comprehensive coverage" through quantum meruit is a myth. Essentially the Rulebook will replicate the problems with the existing arrangements in terms of a lack of ability to enforce compliance, which, without a regulatory requirement to join, relies on parties being willing to enter into contractual arrangements: either a transmission contract with Transpower (under the existing arrangements) or entry into the Rulebook (under the proposal). Quantum meruit is simply another term for relying on the Courts to determine and enforce prices where the parties are unwilling or unable to do so themselves. There is no reason why this would be any more effective as an incentive for joining the Rulebook than the current situation, under which parties have been prepared to face litigation if they are unwilling to agree on pricing for transmission and common quality services.

23. In claiming that the Rulebook will deliver "comprehensive coverage" the Applicant is attempting to claim both the benefits of being compulsory and the benefits of being voluntary. The Applicant has argued that there are "incentives" to ensure full coverage, but at the same time the Rules purport to allow opting-out (as envisaged by the ENA submission referred to at paragraph 13.) There are some internal contradictions within the Rules between being comprehensive and allowing alternative trading arrangements. By trying to have it both ways it achieves neither. The Rulebook, which can come into effect without full industry participation and supposedly enables members to leave, cannot deliver the mandatory provisions needed for security, reconciliation and other common services. At the same time the "incentives" to promote comprehensive coverage (including the requirement that members take the entire bundle of services) remove the benefits of voluntary self-regulation. Self-regulation is successful when it is truly voluntary – where participants choose to join only if joining

provides significant benefits they would not otherwise receive (and that choice then acts as a pressure on the industry body to be efficient and deliver benefits). The Applicant cannot logically claim that the Rulebook effectively delivers mandatory coverage while at the same time retaining the advantages of a voluntary system.

Anti-competitive Rules in the Rulebook

Existing Anti-competitive Rules

24. The Commission has concluded that there is no detriment from existing anti-competitive rules under the Rulebook because the rules under the Crown EGB would initially be the same as the Rulebook in all material respects. This is not the case. The operational rules would initially be similar to the Rulebook, but not exactly the same. Transpower can point to specific instances of anti-competitive rules in the Rulebook that would be unlikely to be replicated under a Crown EGB.

25. One example is transitional dispensations. The Commission appears to have confused transitional dispensations (Part I: Section III: Rule 2) with the six month transitional exemption from full compliance with the Rulebook, (Part I, Section II, Rule 5) as they are discussed in the Draft Determination in relation to the transition to the new arrangement. Transitional dispensations effectively exempt incumbent asset owners from certain security obligations on an ongoing basis,[14] and provide that those individual incumbents will not be allocated the cost of ancillary services required as a result of the dispensation given to them.[15] Instead quantifiable costs arising from the dispensation (including the costs of any additional ancillary services other than kVar costs) will be allocated across all asset owners. The dispensations do not expire, i.e. they do not operate as a period of grace in which to get assets up to standard but a permanent exemption from compliance.

26. Under the counterfactual of a Crown EGB it is likely that dispensations would be applied equally to incumbents and new entrants, i.e. any quantifiable cost that arises from a dispensation will be allocated to the individual asset owner that receives the benefit of the dispensation (in the same way kVar costs are already dealt with under rule 2.5.5).

27. Transitional dispensations are a refutation of the assumption (inherent in Murray & Hansen's analysis) that industry members will create efficient rules for industry based on cost/benefit trade-offs by industry participants.

Potential for Future Anti-Competitive Rules

28. The Commission has not allocated any detriment for anti-competitive rule changes, even though it has recognised that the incentives for anti-competitive rule changes are clearly present being the same incentives leading to pro-competitive

[14] Prior to the Rulebook coming into effect an asset owner may enter into a "qualifying preliminary dispensation" and, subject to satisfaction of varying criteria, on the commencement of the Rulebook that will be deemed to be a dispensation granted in accordance with the Rulebook.

[15] Part I: Section III: Rule 2.5.4. Costs will be shared by all asset owners.

strikedown which the Commission has recognised).[16] Given that these incentives are present, essentially the argument that anti-competitive rule changes would not occur is solely based on the existence and effectiveness of constraints on such developments. Transpower considers that these constraints are likely to be ineffective for the reasons set out below.

Requirement to meet the Guiding Principles

29. The requirement that rules comply with the Guiding Principles will not necessarily prevent anti-competitive rule changes because:

(a) the high level nature of the Guiding Principles makes it difficult to apply them as a constraint against specific proposals. This leaves room for very different interpretations to be argued and makes it difficult to be certain that a particular rule does not meet the Guiding Principles;

(b) there is no absolute requirement on the rules to be pro-competitive. Guiding Principle 3 makes it clear that "where efficient" the rules should foster competition. The presence of the qualifier provides an "out";

(c) consistency with the Guiding Principles is likely to require a balancing of different Guiding Principles. The requirement to apply the Guiding Principles "as a whole" confirms this;[17] and

(d) the Guiding Principles are not themselves entrenched and so could be changed in the future. For example, the Guiding Principles could diverge further from the GPS.

30. The lack of entrenchment, vagueness and potential for inconsistencies between the Guiding Principles suggests that the reliance that can be placed on them as a constraint is limited. The difficulty of relying on high level guiding principles is demonstrated by the various debates on transmission pricing methodologies where there is little dispute over the high level principles set out in documents such as Government Policy Statements and Transpower's SCI, but different customers

[16] Paragraph 401.
[17] Part A : Section IV : Rule 1.3.3.

have very different views on what methodology is consistent with those high level principles.[18]

"Independent" Board

31. The requirement that the persons appointed to the EGB must be independent is not an effective constraint because it fails to recognise the pressures those "independent" directors will face, as they are answerable to the industry. They are appointed by the industry and the industry can, by industry vote, replace the Board. Like any board, they will be acutely conscious of this power and are likely to be cognisant of their primary accountability to the industry in exercising their powers. The lack of independence in the relationship between the Industry EGB and the industry participants is summarised in an Electricity Governance Establishment Committee ("EGEC") paper which characterises the relationship between the members and the Board as being one of principal and agent.[19] The interests of an agent are by definition those of its principal. Furthermore the Board and Rulings Panel will naturally attract personnel who support the concept of industry self-regulation and are likely to be sympathetic towards rules developed by the industry. It is reasonable to assume that they would be less willing to challenge those rules than an independent regulatory body.

32. In any case, the substantive role of the Industry EGB is in reality limited. Except for non-controversial matters, the Industry EGB is not actually making decisions on rule changes but simply putting the proposed change to an industry vote. Even if the Industry EGB decides not to put a working group proposal to an industry vote (for instance because it thinks it is inconsistent with the Guiding Principles) the industry is able to override this decision and approve the proposal though 25% of industry members requiring a vote.

33. The scope for the Industry EGB to act as an independent board is further limited by the structure of the rule change process which focuses consideration of issues on working groups, and decisions on issues on the industry, leaving the Industry EGB as little more than a process manager of working group recommendations. This is discussed further below.

The Rule Change Process

34. The Commission refers to the ability of any person to propose rule changes as a constraint on anti-competitive rules but there is no link between being able to propose a rule change and preventing another person from propagating an anti-competitive rule.

35. On the wider issue of the rule change process as a whole, the Commission relies on the role of working groups, the Rulings Panel and the transparency of the process to act as constraints on anti-competitive rules. None of these are likely to

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[18] The litigation between Transpower and Vector and Meridian provides an example of the extent to which industry participants can differ in interpretation of high level principles: Meridian and Vector were asserting different extremes relating to interpretation of Transpower's pricing methodology. Vector argued that generators were not paying enough while Meridian argued that the same methodology meant generators were paying too much. Both were relying on economic efficiency arguments.

[19] EGEC paper, 14 February 2002, Report from Governance Working Group containing recommendation concerning the new electricity industry governance structure.

be effective. Although the process appears transparent with the opportunity for outside input, the effectiveness of that input is extremely limited.

36. The transparency of the rule change process is illusory for a number of reasons, as set out below, and therefore does not act as an effective constraint:

(a) the Rulebook is not readily available to the public at large. Participants have electronic access to the rules via the Board's website free of charge[20] but the public do not. Any other person must seek a certified copy of the Rulebook from the Board for a fee;

(b) only participants of the Rulebook are permitted to give submissions on proposals;[21]

(c) the Industry EGB only has to notify participants to the Rulebook of rule changes; and

(d) after notification, the participants only have 10 working days to lodge an appeal.

37. Inconsistency with the Guiding Principles is a ground for appeal but this is so wide, and open to such a variety of interpretations, that it would be difficult for the Rulings Panel to say with certainty that a rule change is inconsistent with the Guiding Principles, except for extreme cases.

38. The working groups and Rulings Panel will also suffer from the same limitations as the Industry EGB – they are appointed by the Industry EGB and thus suffer the same lack of true independence from the industry. There is an apparent independence in the appointment of working group members who are to be "selected personally and not as a representative of their employer".[22] However, the rule goes on to require that any member of a working group who changes employers must tender his or her resignation.[23] By focusing on the employer, this latter requirement is clearly inconsistent with the independence of the working group member. The reality is that working group members are there to pursue their employers' interests and it is naïve to assume otherwise.[24]

39. Even assuming that the process, if operated correctly, does theoretically provide an opportunity to limit anti-competitive changes, taking advantage of this process assumes that parties affected by a potentially anti-competitive rule change will have the expertise, opportunity and resources to use the process effectively. While this might be true for Transpower and the large generator/retailers, it is unlikely to be the case for smaller industry participants and consumers. Without continual monitoring and competition assessment of the workings of the Industry EGB and the decisions of the industry it will be extremely difficult to take advantage of any theoretical rights afforded by the process.

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20 Part A: Section IV: Rule 1.16.
21 Part A: Schedule A3: Rule 11.1.1.
22 Part A: Schedule A3.
23 Part A: Schedule A3: Rule 7.
24 [Employment contract requires this.]

The Auditor-General, Parliamentary Commissioner for the Environment and Government

40. The Commission's reference to the overview role of the Auditor General and the Parliamentary Commissioner for the Environment fails to recognise the limitations inherent in those roles. First, the Parliamentary Commissioner for the Environment's role is limited to environmental impacts and thus cannot have regard to the competition effects of the Rulebook. The Auditor-General's review role, although wider, is not focused on competition analysis but measures overall performance of the industry arrangement against the GPS. While the GPS refers to promotion of competition (where possible), it is only one bench-mark, and the focus is on overall performance against widely-framed objectives. There is not going to be (and, Transpower would venture, there is not intended to be) a specific examination of each rule change for potential anti-competitive effect. It is a broad-brush approach which may spot and report on significant trends in performance (if they are obvious to non-experts, which is in itself doubtful) but will not act as a "sieve" to eliminate specific anti-competitive rule changes. In any case, even if the Auditor-General were to look for competition effects, he is not a competition expert. As this authorisation process illustrates, the competition impacts of a proposal are not necessarily obvious.

41. If the review were to spot a competition problem, the remedies are limited. There is no specific ability to unwind a rule change. Essentially the remedy relies on the possibility of Government intervention, presumably to disband the Industry EGB and establish a Crown EGB.

42. Government intervention after the Rulebook is established is an extreme and blunt response. Unless a direct link to lower prices for consumers can be shown, which is not always present or straightforward, rule changes may not be a focus of Government attention. It is possible that Government intervention would follow a long series of blatantly anti-competitive rules. However, it is not correct that this would stop any particular anti-competitive rule change. Given the "after the fact" and annual nature of the Auditor-General's and Parliamentary Commissioner's roles and the Government's response, there is likely to be a considerable time lag between an anti-competitive rule and any resulting intervention. This has two effects:

(a) it weakens the effect of the constraint of intervention (because even if the industry knows a rule will eventually get overturned there is a period during which it can benefit from any anti-competitive rule change); and

(b) there is a cost associated with the duration of any anti-competitive rule that needs to be factored into the assessment of detriments.

43. Furthermore, it is somewhat inconsistent to rely on backstop Government intervention as an effective and appropriate constraint while at the same time finding that a Crown EGB (with a dedicated focus to the issues and much greater specialist expertise and information than the Government as a whole) would be an ineffective decision-making body.

The Commerce Commission

44. The Commission comments that any rule change with an anti-competitive effect would only be able to be put into effect if it results in overriding public benefits and receives an authorisation from the Commission.[25] This assumes that the Commerce Act is itself a totally effective constraint on anti-competitive behaviour.

45. The mere fact that anti-competitive rule changes are outside the scope of the authorisation does not in itself mean they will not happen. The argument adopted by the Applicant is essentially that Rulebook members will not act in an anti-competitive way because that would be illegal. Illegality is not itself necessarily an effective constraint: opportunity and potential gains from anti-competitive behaviour need to be offset against potential losses and penalties. Industry incumbents might well consider an anti-competitive rule change to be worth the risk, even if in the long run, it may be discovered by the Commission and overturned. This is particularly likely if a rule change removes an express and present threat (such as a particular new entrant).

46. Whether or not a rule has an anti-competitive effect will not always be obvious or straightforward even to competition experts, and there will be differing views in each case. The Commerce Act and the potential need for an authorisation is only effective if someone identifies and analyses the competitive effect of each proposal. While obviously the Commission itself has a role in ensuring compliance and taking action against breaches of the law, it does not have the resources to take on a full-time monitoring role examining every decision under the Rulebook to determine if it has a potentially anti-competitive effect. Even if this "monitoring" is undertaken (which is going to be on a piecemeal basis depending on whose interests are affected) the complexities of the analysis and the decision to apply (or not to apply) for an authorisation has a cost. This is a detriment that would not occur in the counterfactual.

47. The Commission's own market concentration approach to mergers and acquisitions essentially recognises that given the incentives and opportunities some firms will act anti-competitively regardless of legal constraints and so the structures that enable such co-ordinated and potentially anti-competitive behaviour need to be addressed. Waiting until those entities engage in anti-competitive conduct is undesirable. The same logic applies here.

48. There is ample evidence that industry incumbents, as is to be expected of any commercial operation, endeavour to influence the rules to suit themselves. The allocation of loss and constraint rentals is a case in point. In the lead up to the establishment of NZEM the industry debated an efficient method for allocating loss and constraint rentals and decided that these should be allocated to the grid owner (i.e. Transpower). Transpower does not retain the rentals but allocates them to its customers (distributors, generators and direct connects) who pay for the grid.

49. In 1999 following the separation of lines and supply businesses, the Market Pricing Working Group considered the allocation of loss and constraint rentals and recommended the status quo (i.e. Transpower being forwarded the rentals by the Clearing Manager who collected them on behalf of both NZEM and MARIA) but

[25] Paragraph 234.

that was rejected by the Rules Committee and a further working group was established to consider the issue. There have been two further attempts by industry to change the rules around losses and constraints to effectively reallocate the rentals to NZEM members or to prevent Transpower using rentals to fund Financial Transmission Rights ("FTRs").[26] The Government became involved and has now issued a draft proposal for implementing FTRs.[27]

Failure to Develop Pro-Competitive Rules

50. The Commission has correctly recognised the potential for strikedown of pro-competitive rules under the Rulebook. However, Transpower considers that "strikedown" may be an inappropriate term in that it refers specifically to the use of voting rights to defeat pro-competitive rule changes at the voting stage. Failure to develop pro-competitive rules stems not only from actual strikedown but from all of the following factors:

(a) the Rulebook entrenches rather than reduces incumbents' market power;

(b) the processes for making and evaluating rules, as well as voting, are likely to be controlled by incumbent power blocs. This results in a lack of ability for new entrants, non-members, consumers or minority groups to effectively promote pro-competitive rule changes; and

(c) the lack of any truly independent and authoritative entity accountable and empowered to enable the rules to develop in a pro-competitive manner.

Integrated Generator – Retailers

51. The vertical integration of generators and retailers (and thus their ability to combine their votes) is likely to result in a powerful industry bloc that will act to limit pro-competitive developments against their commercial interests. Evidence of this is emerging under the existing arrangements. The Market Surveillance Committee ("MSC") has recently expressed concern at the fact that NZEM is, or is close to, oligopoly and consequently it is likely that market participants will have, and be able to use, market power to lessen new entry. [28] The MSC stated that it did have concerns about the structure and operation of the spot market administered by NZEM not only in respect of oligopoly and vertical integration, but also in terms of transmission constraints, demand and market design and rules. Transpower considers that the design and voting arrangements under the Rulebook entrench and strengthen this existing market power.

52. Murray & Hansen's claims that generators will not always exercise market power to inhibit pro-competitive rule changes ignores the reality that by definition pro-competitive rule changes will disadvantage incumbents with market power and any commercially rational firm will act to protect its commercial interests. The

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[26] FTRs are discussed further at paragraphs 59 and 60 below.

[27] The Ministry of Economic Development, has recently released a draft Summary Statement on FTRs following an independent review. The report by Grant Read, dated 8 May 2002, has confirmed Transpower's approach as efficient. The Summary Statement, based on the report, recommends that although the industry remains at an impasse over certain issues, Transpower should proceed with its FTR proposals and that initially the FTR auction proceeds and residual rentals from the interim regime be distributed in accordance with Transpower's currently proposed methodology.

[28] Decision of the MSC into a claimed "Undesirable Situation" arising from high spot prices in May/June 2001. (17 July 2001) p21.

market power enjoyed by generators explains to a large degree the failure of the industry to introduce features aiding demand-side participants, such as mandatory hedges and disclosure of bid offers. Despite consumer pressure for such changes, generators have failed to put them in place. It has taken considerable Government pressure to get the industry to move on this issue.

53. Murray & Hansen challenge the potentially anti-competitive impact of vertical integration on the basis that "it is not obvious why a decision that would be supported (opposed) by separate entities as in (against) their joint interests, would not be supported (opposed) by the combined entity." The Commission quotes this and appears to accept it.[29] Of course, where both blocs would have voted against something anyway their integration will not affect the outcome. However, the situation that raises concern is not where their interests are in fact joint but where they would naturally be expected to have opposing interests. Given that generators are suppliers and retailers are purchasers, there would naturally be expected to be a tension that would act as a real constraint on anti-competitive behaviour. The integration of generators and retailers removes this potential constraint.

54. There is significant evidence that vertically integrated generator-retailers will vote in the particular interest of the generator business. The reason for this is that retailers are largely homogenous – so a generator might be willing to accept a rule that disadvantages its retail arm because it will disadvantage all retailers equally. An illustration of this principle arose in the context of the Cobb Power dispute between Transpower and Transalta (the owner of the Cobb Power Station). Transalta opposed Transpower's pricing methodology which charges South Island generators for the costs of the HVDC link, even though the alternative methodology of charging North Island load would have resulted in Transalta's North Island retail customers paying a higher proportion of the HVDC link than its one small power station was paying. Transalta was not concerned if North Island retailers had to pay as the costs would be levied on all retailers. Transalta's main driver was minimising the transmission charges payable by its South Island-based Cobb power station. This behaviour suggests that generators will use their combined generator – retailer votes to promote their interests as generators at the expense of retail interests. To the extent that retail interests are aligned with those of consumers, this means consumer welfare is likely to decrease. The opposition of consumer bodies to the Rulebook suggests that consumers do not consider the integrated generator retailers are acting as a proxy for their retail customers.

Lack of Ability to Effectively Promote Pro-Competitive Rule Changes

55. Pro-competitive rule changes are unlikely to be introduced because the industry participants who would have the greatest incentive to do so lack the ability to push through such proposals. An obvious example is new entrants, who by definition are not yet members and do not have voting rights. Consumers will have limited voting rights in some situations, but these are likely to be diffused among different consumer groups and small consumers may be under-represented or not represented effectively at all. Furthermore, proponents of a rule change have no automatic right to speak to or make submissions on proposals unless they are a participant to the Rulebook.

[29] Paragraph 237.

56. In addition to actual strikedown of pro-competitive changes through votes, the Commission should also recognise that in many cases pro-competitive proposals will not be introduced because it is pointless for the proponents of the rule change to do so if they will not have the numbers when the proposal eventually goes to a vote. Even if a proposal is introduced it is likely to be defeated well before reaching a vote. The opportunities to bury (or perpetually delay) a pro-competitive proposal prior to a vote are considerable. For instance, as the Industry EGB has the power to "prioritise" proposals, a useful but not highly visible tactic is to simply give an unpopular proposal a "low priority". Even assuming a proposal is considered by a working group, the working group – made up of industry participants answerable to the Industry EGB – can recommend not to take it any further or defer it, or suggest re-prioritising it. If the Industry EGB accepts that recommendation to reject the proposal that decision is irrevocable and it seems likely a great many pro-competitive proposals will simply never make it past the working group stage.

57. Assuming that hurdle is overcome and a working group recommends a rule change, the Industry EGB can refer that recommendation back to the working group if (among other reasons) the recommendation is not acceptable to the Industry EGB. It is not difficult to see how this process could be used to reject or substantially delay an unpopular proposal. The latter is a particularly effective technique as it is usually possible to justify such delays on the basis that the proposal needs further consideration and stonewalling can be difficult to prove.

Examples of Failure to Develop

58. These failures are not, on the whole, characterised by actual voting-down of pro-competitive proposals, for the simple reason that it is pointless putting forward a formal proposal that has no chance of success. However, Transpower can provide examples of how pro-competitive proposals have been delayed in working groups or decisions on adopting them deferred.

59. An example of the industry delaying a pro-competitive development is illustrated by the ongoing debate over the introduction of FTRs. Transpower wishes to use losses and constraints rentals to fund FTRs and to then distribute the proceeds of auctions for FTRs to transmission customers.[30] However, a number of generator/retailers have sought to control the rentals themselves,[31] and while there is general agreement that there is a need for a transmission hedging product of some description the industry cannot agree on how to achieve the aims of a more efficient allocation. The industry accepts Transpower's FTR proposal as "theoretically sound" but has to date failed to agree on a specific implementation proposal.

60. The further NZEM rule change proposals illustrate attempts by industry members to change the rule relating to loss and constraints rentals for their commercial advantage. As the parties have been unable to agree on the introduction of FTRs

[30] A draft Summary Statement by the Ministry of Economic Development, dated 8 May 2002, has confirmed Transpower's approach as efficient.

[31] The industry's proposals to take control of losses and constraints from Transpower has the additional effect of stopping FTRs because Transpower intends to fund FTRs through those rentals.

the Government has stepped in and has issued a draft Summary Statement of the proposed approach, which supports Transpower's approach as efficient.[32]

61. While this lack of progress has occurred under the existing arrangements, similar (or worse) results are likely under the Rulebook. The Rulebook consolidates and extends the opportunity for industry incumbents to control industry developments to promote and protect their own interests, so it is likely that the instances of blocking and delay will not only continue but potentially increase under the Rulebook. There are no examples of blocking of pro-competitive changes in relation to common quality, because that is still set by Transpower's CQO (as MACQS has never become operational). If the Rulebook comes into effect Transpower would expect to see similar examples of industry delay and reluctance to advance in relation to common quality issues.

62. A further method of assessing the extent of failure to develop in a pro-competitive manner is to examine an example of a developed electricity regime that does have a regulatory authority and compare the changes that have occurred with those that have occurred within the New Zealand industry. An example is the PJM market.[33] Transpower has asked Professor Bill Hogan, an international expert on electricity reform, to address this point in his submission to the Commission.

No Entity to Ensure Pro-Competitive Development

63. One of Transpower's main concerns with the Rulebook has always been the absence of an independent decision-making body which would be established to make decisions in the public interest – including promoting competition. The GPS envisages an Industry EGB where there is an independent Board accountable for delivering the GPS outcomes. For the reasons discussed in this section, and in the section on decision-making that follows, the Industry EGB does not fulfil this function. The Industry EGB cannot effectively be held accountable when its role is limited to overseeing process and the Rulebook is intended to be controlled by industry decision-making. In the absence of an independent industry body, there will be no effective backstop constraint on the industry.

64. The Commission has suggested that the voting down of pro-competitive changes will not occur as readily as the incentives might otherwise dictate because such votes will be readily apparent and thus lead to Government intervention. This underestimates the complexity of the process and overestimates the level of Government monitoring that is likely to occur on an issue-by-issue basis. Voting down may not be readily apparent (even assuming proposals get to a vote). It requires constant surveillance, together with the expertise to evaluate the competition ramifications of each proposal (assuming there is one) to even appreciate the fact that a pro-competitive change either has not been introduced or has been deferred, diluted or defeated in the process. Competitive impact is not always easily determined and may involve a complex analysis. This is likely to be

[32] See paragraph 49 above.

[33] PJM is the electricity system in Pennsylvania/New Jersey/Maryland Key features of PJM have been adopted by Federal Energy Regulatory Commission ("FERC") as the Standard Market Design. Essentially, PJM's governance structure is very different to that proposed for New Zealand. Anyone who wants to participate in the electricity market in the PJM area must become a member. PJM acts as the system operator and the market operator. The structure is more complex with the state regulating lines businesses and FERC, as national regulator, regulating the market. PJM is responsible for making new investment decisions in both generation and lines, by granting licences to recover investment.

particularly hard for players not already in the market who do not have the same access to information as existing market participants.

65. Furthermore, while Government will still have the ability to pressure industry under the Rulebook in an ad hoc manner, (as it has done, eventually, with FTRs and mandatory hedges), this is not an efficient, transparent or accountable method of achieving change. The counterfactual addresses accountability by ensuring Government's role is through a Crown EGB with clear decision-making responsibilities and accountabilities. For this reason, overseas jurisdictions have established specific regulatory bodies to monitor the behaviour of industry players, and provided them with specific powers to counteract the market power of those participants.

Differences in Decision-Making Capability

66. The Commission has assessed that the industry would have superior rule and decision-making capabilities relative to the Crown EGB, with resultant production and dynamic efficiency gains. Transpower disagrees with the Commission's analysis and believes that it assumes too big a difference between the likely competence of each entity and fails to take into account the negative impact that self-interest will have on decision-making under the Industry EGB. The reasons for this are discussed below and are also discussed in NZIER's and Professor Hogan's submission. Professor Hogan highlights international experience of industry decision-making.

67. Transpower also disagrees with the Commission's conclusion that higher transaction and compliance costs are likely to result under a Crown EGB.

Ability to Use Information Effectively

68. Transpower disagrees with the Commission's assessment that the industry will have better access to information and ability to use that information for the following reasons:

(a) the industry may have more information but will not have "better" (in the sense of achieving efficient pro-competitive outcomes) information. The Industry EGB is likely to have less information than the Crown EGB;

(b) under the Rulebook decisions will be made by industry participants, not the Industry EGB. Information and knowledge collected through the Rulebook processes flowing to the Industry EGB will not necessarily flow through to the industry and so may not assist decision-making by individual industry participants;

(c) industry participants voting in their own commercial self interest will not make decisions in the interests of overall competition and efficiency;

(d) working groups will be common to both the Industry EGB and Crown EGB process. It is likely that a Crown EGB will make better use of working groups and be better informed on working group decisions than the Industry EGB. (In his accompanying submission, Prof. Hogan describes experience in the US suggesting that the ability of a regulatory

authority to make independent decisions is "…not as an impediment to receiving good industry advice but rather as providing an incentive for industry to give the best advice possible…"); and

(e) lobbying on important areas of market development will be common to both the Industry EGB and the Crown EGB.

Decision Makers

69. Transpower considers that under the Crown EGB, the Crown EGB itself and not the Minister is the primary decision-making body. The Minister has no power to make any regulations in relation to the wholesale electricity market, common quality or transmission issues (i.e. the matters dealt with under the Rulebook) unless implementing an EGB recommendation.[34] If the Minister does not adopt an EGB recommendation the Minister can only defer a decision, refer the recommendation back to the EGB or decide not to act. If the latter, the Minister must publicly explain the reasons for such a decision. This means that substantive decisions will primarily be made by the Crown EGB, a specialist and expert entity.

70. By contrast under the Industry EGB, the Industry Board is a process manager with very limited decision-making responsibility. Real decision-making power lies with industry participants under the industry voting arrangements. The Industry EGB will be limited in its ability to influence or constrain industry participants and there is no single entity or person accountable for industry decisions. This limitation is compounded by the fact that the Industry EGB will have a significant informational disadvantage compared to industry participants. The requirement for apparent independence means the Board members will have limited current knowledge and experience of the industry. Board members will also be "part time".

Information Flows

71. The conclusion that "the industry is likely to have greater information to evaluate the merits of a proposal than the Crown EGB"[35] assumes that knowledge is based only on commercial interests. Commercial interest is clearly a driver to being informed, but it is not the sole driver. In some cases commercial incentives will stand in the way of a thorough and balanced understanding of an issue, including taking into account information that is in the public interest (e.g. medium to long term decisions on security). Parties might have good knowledge about issues from their own commercial perspective but it may not suit them to get a more objective view or seek out knowledge that does not correspond with their interests.

72. Transpower believes that a Crown EGB is likely to follow similar processes to that adopted by NECA,[36] where working groups are chaired by members of the Crown EGB. This will provide the Crown EGB with a high level of information, not dissimilar to that of the industry and a much higher level of information than the Industry EGB.

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34 Electricity Act 1992, Sections 172E and 172Z.
35 Paragraph 400.
36 The National Electricity Code Administrator in Australia.

73. In addition, the Crown EGB is likely to be proactive in seeking out information both locally and as to international practice. The EAA imposes obligations on the Crown EGB to consult with persons that are representative of the interests of persons likely to be substantially affected by any proposed rule change.[37] The Crown EGB must also have regard to the objectives set out in the EAA.[38]

74. There will inevitably be issues where relevant information is commercially sensitive. In such situations, the Crown EGB is likely to be better informed overall than the industry under the Rulebook because industry participants will be more likely to provide information to a neutral Crown EGB than to other industry players who could benefit from commercially sensitive information. To the extent information goes to working groups on a confidential basis such information will not contribute to efficient decision-making under the Industry EGB, because it will not be available to inform the wider group of decision makers under an industry voting process.

75. Overall, the Crown EGB – the primary decision maker under the counterfactual - will have a high level of information on which to make decisions. By comparison, under the Rulebook, individual market participants (who are the decision makers) will have less information relevant to the public interest to inform their decision-making than the Crown EGB.

Overall Quality of Decision-Making

76. In its assessment of decision-making capability, the Commission acknowledges that industry will be driven by its own commercial self-interest, "which may not always be in the interests of overall efficiency".[39] Transpower considers that the commercial self-interest of industry will detract from the overall quality of decision-making. The negative impact of industry self-interest will be felt in all aspects of the decision-making process because the ultimate control of the processes (and personnel involved in the processes) lies with the industry.

77. The Commission suggests that the prioritisation of work streams will be different under the Crown EGB which will give higher priority to GPS policies (which include competition as well as possibly wider issues). In contrast, an Industry EGB will focus on "operational efficiencies which are aligned to the commercial interests of the parties."[40]

78. Transpower agrees with the Commission's assessment that the Crown EGB will be more focused on considering proposals which have the objective of improving competition and efficiency in the electricity market, but disagrees that this focus will be at the expense of considering proposals that will deliver operational efficiencies.

79. Another reason why rules affecting operational efficiency will still be raised under the Crown EGB is that the same scope will exist under both arrangements for any person (including industry participants interested in promoting operational efficiency) to propose a rule change. In assessing priorities for considering such

37 Electricity Act 1992, section 172E(2)(b).
38 Electricity Act 1992, section 172E(2)(c) and section 172T.
39 Paragraph 406.
40 Paragraph 396.

proposals, the Crown EGB will be likely to have regard to the objectives in section 172E(2)(c), which have a strong focus on efficiency.

80. To the extent that "higher priority" is given to the GPS under the Crown EGB, this also carries a public benefit. Murray & Hansen take an overly narrow view of public benefits as being confined to what is efficient for the industry.[41] While there will usually be a high degree of overlap, wide policy objectives as expressed in the GPS (and not reflected in the Guiding Principles) can also contribute to public benefit. To the extent that the Crown EGB is more likely to make decisions that are consistent with the GPS, this should be counted as a public benefit.

Working Groups

81. Working groups are common to both the Rulebook and the counterfactual and are likely to be the key forum in which information is exchanged and analysed under either scenario. Working groups are likely to have a more central role under a Crown EGB than an Industry EGB because under the Rulebook real decisions are not made by the Industry EGB but are decided by an industry vote. Under the Crown EGB working groups are likely to be a key forum for persuading the Crown EGB to support (or oppose) a proposal. Industry participants at working group level will be driven by commercial self interest, and it is unrealistic to think otherwise. As already noted, the Industry EGB will have a significant information disadvantage compared to the industry and will have limited ability to assess and critique any working group recommendation. By comparison, the Crown EGB will have a significantly greater understanding of industry issues, and is likely to have participated in the working group process as well as seeking out independent information.

82. Transpower does not agree that concentration of decision-making power in the Minister could lead working group participants to adopt more extreme positions on proposed rule changes,[42] or that under the Industry EGB parties would tend toward the norm through a need to gain sufficient voting support. This suggestion is based on an assumption that compromise of industry interests resulting in an efficient "win-win" outcome for all participants is a likely outcome. This is not necessarily the case. In many cases industry participants will have opposing interests, will be reluctant to compromise and an "efficient" or pro-competitive outcome is largely dependent on whether the stronger party's interests are coincidental with efficiency.

83. Examples from the NZEM suggest that members will not easily compromise their commercial positions simply in order to obtain a result – and in fact the reverse is true as the ongoing FTR debate illustrates. If given the opportunity (as they will be through voting rights in the Rulebook), participants will dig their heels in to protect their commercial self-interest. To the extent that members are driven by commercial imperatives to negotiate a compromise, this is more likely to involve commercial trade-offs than promotion of the public good.

84. Under the Rulebook it is more likely that there will be deals which benefit only the number of industry participants whose votes are needed for the proposal to

41 "The basic premise is that the institutional structure most conducive to correct decisions, will best facilitate the efficient functioning of the electricity industry and thereby create the maximum public benefit". Murray & Hansen, para graph146.

42 Paragraph 402.

progress. This will be at the expense of either the industry participants who are in the minority when the votes are cast (or perhaps do not have votes at all under the relevant chapter) or the general public interest. By contrast the Crown EGB as a specialist agency will have sufficient knowledge to recognise rules that only advance self-interest and will require rule changes to be examined against their effect on all interested parties and wider public interest.

Lobbying

85. Transpower considers that lobbying will be common to both the Crown EGB and the Industry EGB but will be more transparent under the Crown EGB. Under the Industry EGB the Minister will still have a significant degree of influence and reserve powers of regulatory intervention, and under both regimes electricity matters are still of political significance and influence, as Transpower pointed out in its initial submission.[43] If anything, lobbying of the Minister is likely to be greater under the Industry EGB, as under the Crown EGB much of the lobbying is likely to be directed to the Crown EGB and through the working group process. Transpower considers that the Minister is unlikely to depart from Crown EGB recommendations except in exceptional circumstances. As a specialist agency one of the key roles of the Crown EGB will be to acquire the knowledge and skills to appropriately assess industry views and positions and to make recommendations to the Ministers.

86. Furthermore, lobbying under an Industry EGB is likely to lack transparency compared to a Crown EGB. Without transparency or accountability, lobbying (as occurs under the existing arrangements) is likely to result in poorer decision-making. In addition, under an Industry EGB there will be a "double-dose" of lobbying as participants will need to lobby both the industry (for supporting votes) and also the Government if the industry fails to act (or acts in a way that does not suit other participants).

87. The statement in the Draft Determination that decision-making will be less efficient under the counterfactual because a Crown EGB would have to compete with other policy matters for the Minister's attention does not take into account that the very purpose of a Crown EGB is to be a specialist and expert body the Minister can rely upon without having to spend time himself or herself considering the merits of a proposal.

Transaction Costs

88. Transpower disagrees with the Commission's assessment that higher transaction and compliance costs will result under a Crown EGB. The working group processes, lobbying and external advice will be features of both the Rulebook and the Crown EGB. Some of the Rulebook costs will be absent from a Crown EGB – e.g. calculation of voting entitlements (which will need to be separately calculated for each vote) and management of the voting process.

89. Lobbying under the Rulebook is likely to be comparable to lobbying under the Crown EGB. The current issue in relation to FTRs is an example of Ministers and

[43] At paragraph 71.

Officials being involved in an industry decision-making process when industry participants have been unable to agree on an issue.

Conclusion on Decision-Making Capability

90. In conclusion, both the Industry EGB and the Crown EGB will involve lobbying, external advice and prioritisation of decision-making. The difference is that under the Rulebook, information will flow to working groups but real decision-making power is exercised by the industry which will be driven by commercial self-interest, and lack accountability on pro-competitive objectives. In contrast decision-making under the counterfactual will be centred on a specialist Crown EGB with the ability to obtain and independently assess information without commercial incentives competing with its role of recommending decisions and rules that are efficient and pro-competitive for the industry as a whole.

Transmission Investment

The Risk of Over-Investment

91. The Commission has stated that there is a greater likelihood of over-investment under a Crown EGB than an Industry EGB.[44] The main basis for this appears to be that the Crown EGB would be held responsible for the consequences of a failure to relieve a constraint but would not be responsible for paying for new investments itself. Thus its safest course of action would be to overinvest.

92. Transpower disagrees. While the Crown EGB would assume the role of investor of last resort and would probably "adopt a relatively risk averse stance to investment"[45] compared to the Industry EGB, the word "relatively" is important. It would be more risk averse than the Industry EGB, which the Commission has agreed would be likely to under-invest. This does not mean that the Crown EGB would overinvest, but rather brings it closer to an efficient investment point. There are two principal constraints on over-investment: checks in the Part F process and checks on the transmission provider.

93. There are inherent checks on investment through the Crown EGB process, in particular the Part F voting processes for new investment. Transpower agrees with the Commission that the operational rules under the counterfactual would mirror the Rulebook except in respect of the investor of last resort role played by the Crown EGB. The same rules that will result in under-investment under an Industry EGB will, under a Crown EGB, act as a counterbalance to the possible risk of over-investment.

94. It is important to realise that under the counter-factual the Crown EGB will only be able to sanction investment to change service levels (without customer approval) under very limited circumstances. Transpower would expect that under a Crown EGB the constraints on appeals to the EGB, which limit any potential for decision-making by the EGB and contribute to the potential for under-investment in the grid, would be absent. However the existing rule 4.1.2 of section II of Part F is likely to be retained and provides a more useful and appropriate constraint on

[44] Paragraph 328.
[45] Paragraph 427.

the Crown EGB's decision-making role. Under this rule the EGB is only able to intervene and direct that a service change, rejected by a customer vote, should in fact proceed, if two such votes have been held and a year has elapsed between these votes. Through this rule the potential benefits of allowing a market for investment to work wherever possible, are acknowledged.

95. Furthermore, in accordance with the GPS, the Crown EGB's decision-making role as investor of last resort (i.e. without customer agreement) will only be able to be exercised if it is satisfied that:

(a) the costs of relieving a constraint or mitigating security risks outweigh the costs of those constraints or risks; and

(b) alternative responses (i.e. responses such as demand side management) are not adequate to resolve the issue. [46]

The Crown EGB will have a high level of information on which to make such decisions because it will have access to all the information used by customers under the Part F process. This access to information will help avoid over-investment. Finally the Crown EGB will have to publicly and transparently justify any decisions that are reached without customer agreement.

96. The assumption of over-investment also ignores the role of the transmission provider. If the transmission provider is not in favour of new investment, the Crown EGB is likely to take account of this given the transmission provider's extensive knowledge of the risks and benefits involved. There are continuing checks and balances within Transpower (as the current transmission provider) against over-investment. In addition, the rules in Part F which are likely to be retained under the Counterfactual require that a transmission provider (or provider of services that substitute for transmission service) must take a service change proposal through the decision-making process specified in Section II of Part F.

97. The first external check on Transpower is the underlying regulatory regime for lines companies. The valuation thresholds within the current ODV methodology include both "optimisation" and "economic value" tests. These tests ensure that Transpower's asset value only reflects the efficient costs of investments that correspond to a notional "optimal" grid configuration. This represents a level of assets that are used and useful, regardless of whether customers (because of issues such as externalities and free-riding), have expressed willingness to pay for the specific investments. If Transpower invests above the appropriate valuation threshold it would be unable to recover the cost of such investment, without generating excessive rates of return that would (under the proposal regulatory thresholds) be expected to result in some form of regulatory action. This risk means that Transpower would be very unlikely to proceed with an "over-investment". [47]

98. Transpower notes that while the exact nature of the future regulatory regime for (large) lines businesses is still under consideration by the Commission.

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[46] GPS, paragraph 17 of the objectives and principles for provision of transmission services.

[47] It is not clear the extent to which (if at all) a Crown EGB mandated investment would overwrite the ODV valuation principles applicable to Transpower. There is also the Commission's price control role.

99. A further check on Transpower's ability to invest inefficiently is Transpower's government ownership and the requirement to comply with its SCI, which has been (and is likely to continue to be) efficiency focused (i.e. the requirements to promote the Government's energy policies and produce services at least overall cost).

The Risk of Under-Investment

100. The Commission has correctly identified the risk of under-investment stemming from an Industry EGB (primarily that the parties voting on investment decisions do not want the burden of paying for investment).

101. This risk is supported by Transpower's experience in recent years where transmission purchasers have been unwilling to bear the cost of investment. There were a number of complaints last year from generators at the effect of constraints on the grid during the unusual Winter 2001 flows. Notwithstanding the alleged effect of the constraints on the generators who were blaming the presence of constraints for high prices none of the generators were willing to pay to have lines upgraded and the constraints removed. Similarly, notwithstanding concerns over security levels in the Auckland region and agreement between Transpower and its distributor customers on the technical measures to address these concerns, customers have not been willing to contract to pay for the necessary new investments.

102. Transpower notes that although Part F provides for voting on investment by the member parties receiving the benefit of the service (usually but not necessarily distributors), just because members benefit from an investment does not necessarily mean that those beneficiaries will be willing to pay (in whole or in part) for the cost of that investment There are two issues in particular that lead to such behaviour:

(a) transmission customers will not vote for investments that are dynamically efficient if their own commercial interests do not align with efficient outcomes. The reasons for this are discussed in more detail in paragraph 103 below; and

(b) the free-rider risk that, in the absence of surety over comprehensive membership of the rules, there is the possibility of non-members benefiting from the investment without having to contribute to the investment cost.

103. In the absence of provision for appeal to the Industry EGB, Multiple beneficiaries voting on investment decisions, is likely to result in under-investment for a number of reasons, namely:

(a) different parties may have different ideas of what counts as a benefit;

(b) the 75% threshold required is very high, meaning that an investment can be blocked even when supported by a significant majority of affected customers;

(c) although the intention is for voting to reflect benefits received from the change in service, it is likely that in most cases lines companies (as Transpower's main customers) will have the most votes. The lack of incentives on lines companies to accurately represent end users' interests (when end users are the beneficiaries) may mean that lines companies do not vote for beneficial new investment;

(d) if retailers rather than lines companies are "transmission purchasers" and therefore parties voting on a new investment, similar incentive issues arise. Retailers will also be concerned that new retailers will be able to enter a market and free ride on their investment;

(e) customers' calculation of the cost/benefit of new investment may include only the direct costs of failure to invest and may not include indirect costs such as the reputational costs for a region or a country of an event like the Auckland CBD cable failure;

(f) current management responsible within the transmission purchasers for voting may be focused on short-term returns, and may not want to incur expense today to preserve security for the medium or long-term in the context of commercial pressures;[48] and

(g) under an Industry EGB there is no one person or entity accountable for lack of investment decisions and consequent security implications. If something goes wrong due to a failure to invest (particularly if the relevant decision not to invest was made years before) it is going to be difficult to point to a particular party – and even if they can be identified there is no recourse against them.

104. In conclusion, Transpower considers that the risk of under-investment under the Rulebook is much more likely than the risk of over-investment under the Crown EGB. However, to the extent that there is a risk of sub-optimal investment decisions either to under-invest or to over-invest, then over-investment is preferable in competition terms. This is because grid investment breaks up regionalisation and thus reduces the market power of incumbents. The effect of this market power is not usually factored into the cost-benefit investment analysis (partly because it is difficult to quantify but also because while reducing market power is pro-competitive, it may not be a "benefit" to the customers paying for the investment). However, clearly this is a benefit that should be offset against any risk of over-investment from the Crown EGB.

Contestability of Service Provision

105. The Commission indicates a view that the system operator and other service provider roles are more likely to be contestable under the Industry EGB than under a Crown EGB (and has allocated a significant value to that possibility).[49] There seems to be no basis for this approach other than a somewhat outdated assumption regarding the conservative nature of the Crown in seeking contestable services, as

[48] The Auckland Electric Power Board's delayed investment in reinforcement for the Auckland CBD is also an illustration of this.

[49] We assume that the Commission means contestable but single providers, not competing providers simultaneously offering the same bundle of services to the market.

contrasted with the supposedly greater willingness of the Industry EGB to tender out such roles. Transpower considers that initial contestability of the market administration and system operator role, at least, is relatively unlikely in either scenario. Neither a Crown EGB or an Industry EGB would be likely to immediately change from the incumbent system operator and market administrator because of the knowledge the incumbents have and the need for stability in a changing governance environment. This is supported by the fact that EGEC has appointed its agent to negotiate with M-co and Transpower for future service provision. Equally in the future both a Crown EGB and an Industry EGB will be looking to reduce costs and if efficient to do so will make the service provider roles contestable.

International Experience

106. The Applicant has attempted to paint the Rulebook as an evolutionary development of the existing voluntary arrangements that is both natural and logical. This rose-coloured view fails to recognise the fundamental shift in direction that the Rulebook represents away from international practice. While there is of course no need for New Zealand to follow the rest of the world, questions should be asked of such a radical departure. Overseas electricity markets are dealing with the same issues facing New Zealand. While the details and deregulation and privatisation of electricity (and other utilities) internationally have differed, it is interesting to note that no major economy has successfully adopted an entirely industry-driven and industry-governed governance structure. All include some form of regulatory authority.

107. Moreover, where there have been examples of allowing industry participants unregulated ability to make decisions in respect of market design there have been notable failures. Transpower has asked Professor Bill Hogan of Harvard University to address this issue in his expert submissions.

Conditions

108. The Commission has asked interested parties to consider whether there are any possible conditions that could be attached to the arrangement which would be sufficient to alter the balance of detriments and benefits so as to enable an authorisation.

109. Transpower has given considerable thought to possible conditions. There are a number of minor matters that (were other substantive matters not at issue) could be dealt with by way of conditions. For example, the transitional dispensations could be amended to remove the cost discrimination against new entrants.

110. However, it will be obvious from the foregoing that Transpower's objections to the Rulebook are fundamental. Therefore, any conditions to meet these concerns would have to be equally fundamental. Indeed, Transpower assumes that the conditions the Commission might anticipate could not be minor or trivial, given the significant detriments associated with the Rulebook.

111. Transpower submits that any conditions that made such fundamental changes to the nature of the proposal would be inappropriate in that they would effectively amount to an amended application. It is unacceptable for conditions to be used to

alter the application at this late stage without the revised application going through the due process applicable to all applications for authorisation. Transpower considers that it would be extremely difficult for substantive conditions to be properly assessed, taking into account the views of interested parties, at this stage of the proceedings. Even if parties were to be given the opportunity of considering conditions prior to the conference, this would not compensate for the lack of opportunity to make formal written submissions in advance of the Commission's consideration of the matter. Transpower considers that any decision to include conditions in this manner may be subject to judicial review.

112. Secondly, Transpower cannot at this stage conceive of any conditions that could address the anti-competitive implications of the Rulebook while maintaining its supposed benefits. Any minor conditions would not have any real competitive effect. Major conditions would require a complete reassessment of competitive impact and it is hard to see how the claimed benefits of industry superiority could be maintained while addressing the detriments associated with that same industry control.

APPENDIX 1

References to paragraphs are references to paragraphs in Transpower's submission to the Commission dated 22 May 2002, unless otherwise stated.

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

   Refer to paragraphs 4-7 dealing with the scope of the authorisation.

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

   Transpower accepts the Commission's definition of the relevant markets for the purposes of this analysis.

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

   Transpower does not wish to comment on whether the wholesale pricing mechanism falls within the ambit of s 30 at this stage.

4. *Does the transmission pricing methodology in the proposed arrangements breach s 30?*

   Transpower does not wish to comment on whether the process for adopting a transmission pricing methodology is falls within the ambit of s 30 at this stage.

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

   Transpower agrees with the Commission that the cost allocation provisions fall within the ambit of s 30.

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

   Transpower agrees that the pricing for Rulebook services to non-members falls within s 30. Refer to questions 4-6 above in relation to the other proposed pricing arrangements.

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

   Refer to paragraph 8.

8. *Is there a divergence between the GPS and the Guiding Principles that results in a detrimental effect on competition or consumer welfare? [NB: Transpower notes it*

is answering Q8 as it appears in the Draft Determination at p50, not as it appears in the List of Questions at the end of the Draft Determination.]

Transpower believes that there are key divergences between the GPS and the Guiding Principles which have a detrimental effect on competition and consumer welfare. Transpower considers the GPS has a greater focus on improving competition and consumer welfare. Consumer interests are given a high priority in the GPS which has as its principal objective "to ensure that electricity is delivered in an efficient, fair, reliable and environmentally sustainable manner to all classes of consumer". Transpower's attempts to have this included as a Guiding Principle in the Rulebook were rejected.

Transpower notes that a key feature of the GPS is having a Board accountable for ensuring development of rules consistent with the GPS. Transpower believes that the Rules and the Guiding Principles diverge from this key feature in restricting the EGB's role to overseeing process and instead making industry voting accountable for development of the rules. Furthermore, Transpower notes that the divergence that currently exists could increase, given that the Guiding Principles are not entrenched.

9. *Would the proposed voting arrangements be likely to lessen the likelihood of the implementation of desirable pro-competitive rule changes?*

Refer to paragraphs 50-65.

10. *Under what circumstances would affected parties be likely to have sufficient commonality of interest to vote collectively against recommended pro-competitive rule changes?*

Refer to paragraphs 51-54 in respect of generator/retailer decision-making, and paragraphs 50-65 generally.

11. *What examples are there in existing NZEM, MACQS and MARIA governance arrangements of pro-competitive rule changes being voted down?*

Refer to paragraphs 58-62. MACQS is not yet operative. Pro-competitive rule changes tend not to be developed as proposals unless they coincide with industry participants' commercial interests and are likely to attract the necessary degree of support to pass an industry vote. Rule changes which do not have the numbers for a vote are unlikely to become formal proposals.

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

Pro-competitive development has been limited. In some cases where it has occurred (e.g. retail customer switching in MARIA) it occurred only as a result of Government intervention. The industry is not likely to adopt pro-competitive changes of its own accord unless such changes coincide with industry participants' commercial interests. Furthermore, ad hoc Government intervention following industry failure is less efficient, accountable and transparent than decision-making by a specialist Crown agency. As stated above, MACQS is not yet operational.

13. *What rules in the proposed Rulebook have the potential to be changed in a way that would enhance competition?*

Given the time constraints Transpower has not been able to assess every rule to ascertain whether it has the potential to be changed in a way that would enhance competition. Transpower has focussed on the issue of governance and the existence of anti-competitive rules and the lack of development of pro-competitive rules.

14. *From the consumer perspective, do the proposed voting arrangements give rise to any concerns, and if so in what areas?*

As noted above the Guiding Principles and Rulebook do not reflect the GPS's focus on consumer welfare. The industry controlled voting arrangements are unlikely to deliver benefits to consumer welfare unless the interests of consumers and those of industry participants coincide on a particular issue.

15. *What services would be likely to be provided on a competitive basis under a Crown EGB? How does this situation compare with the proposed arrangements?*

The Commission notes that administration, pricing and clearing services could possibly be competitive under the counterfactual. Transpower believes this maybe true in respect of administration but it is unlikely to be the case for pricing and clearing.

Transpower does not believe that pricing (and the resulting clearing/settlement) can be treated separately from security, dispatch and reconciliation processes. The Commission correctly notes common application of these processes is necessary for the operation of the market. Pricing in the spot market is a direct consequence of the dispatch process, which takes the bids and offers and dispatches generation to meet the load. There is therefore a common application of the dispatch-based spot pricing and this too should be considered along with dispatch as a provision that would be mandatory in both the proposed arrangements and the counterfactual.

In both the Rulebook and the counterfactual, it is only the dispatch-based spot pricing that is mandatory, not pricing generally. Pricing in general terms includes pricing under other contractual trading arrangements (e.g. bilateral contracts) which are outside the mandatory requirements.

Similarly, there is a component of clearing/settlement that is mandatory, that corresponds to the mandatory spot pricing component. For any quantities that are bought and sold in the spot market, the pricing and clearing/settlement will be common to all market participants, under the proposed arrangements and the counterfactual.

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

To the extent that non-members are forced to pay for services such as administration that might not be mandatory under a Crown EGB, the Rulebook pricing does lessen competition.

17. *Would the provisions of Part C of the Rulebook relating to common quality lessen competition compared with the counterfactual?*

Yes. Refer to paragraphs 25-27 on transitional dispensations which is an illustration of how the industry has applied common quality standards in a manner that discriminates against new members.

18. *Would the provisions of Part D of the Rulebook relating to metering arrangements lessen competition compared with the counterfactual?*

Transpower does not wish to comment on Part D of the Rulebook at this stage.

19. *Would the provisions of Part E of the Rulebook relating to registry information and customer switching lessen competition compared with the counterfactual?*

Transpower does not wish to comment on Part E of the Rulebook at this stage.

20. *What are the likely differences in ability between an Industry EGB and a Crown EGB to assess pricing methodologies, and what would be the benefits and detriments associated with any differences?*

The actual ability of decision-makers is likely to slightly favour the Crown EGB (for the reasons discussed in relation to general decision-making capacity at paragraphs 66-90. The quality of final decisions will be lower under the Rulebook because of potential distortion of efficient transmission pricing methodology decisions by the Industry EGB's concern with the commercial interests of industry participants.

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

Transpower's Transmission pricing methodology is designed to promote economic efficiency with emphasis on dynamic and allocative efficiency of the industry at large by minimising distortions to nodal price signals. The parties currently paying HVDC costs have every commercial incentive to transfer that allocation to other parties. Conversely, parties not currently paying HVDC costs have every commercial incentive to ensure they do not attract an allocation of the costs. The Industry EGB would be more predisposed to the commercial interests of the parties it represents but subject to the arguments of both the beneficiaries and "losers". A Crown EGB would (like Transpower) be more predisposed to an efficient allocation of transmission sunk and fixed costs and more immune to the redistribution of commercial outcomes. Both Crown and Industry EGBs would have to consider efficiency, however the Industry EGB would only be incentivised to consider efficiency to the extent that it prevents intervention by the Government. The rectification of any existing inefficiencies would likely be better considered by a Crown EGB, because of the differing biases between Crown and Industry EGBs – efficiency against commercial interests.

22. *The Commission invites comment on its assessment of the arrangements for pricing and investment decisions under the counterfactual.*

Transpower refers to its responses to questions 20 and 21 and otherwise agrees with the Commission's assessment.

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

Refer to paragraphs 91-104.

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

Refer to Transpower's answers to questions 20 and 21.

25. *Would the provisions of Part G of the Rulebook relating to trading arrangements lessen competition compared with the counterfactual?*

Transpower does not wish to comment on whether Part G of the Rulebook lessens competition compared to the counterfactual at this stage.

26. *Would the provisions of Part H of the Rulebook relating to clearing and settlement lessen competition compared with the counterfactual?*

Transpower has no comment to make on this issue at this stage except to draw the Commission's attention to recent attempts to amend the NZEM rules (the equivalent provisions are currently set out at rule 14 of Part H) to remove the requirement for loss and constraint rentals to be paid to the grid owner. The rule change proposals are intended in order to prevent the introduction of FTRs. If these rule changes were implemented in the rulebook (and the generator/retailer controlled governance of Part H facilitates such a change) the amended rulebook would clearly lessen competition compared to the counterfactual.

27. *Would the provisions of Part I of the Rulebook relating to implementation and transitional issues lessen competition compared with the counterfactual?*

It appears the Commission has misinterpreted transitional dispensations as being limited to a six month period when they in fact exist in perpetuity. Refer to paragraphs 25-27 for fuller discussion.

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

Transpower agrees with the Commission's usual approach to valuing public benefits but notes that while the emphasis is on measuring these benefits in terms of economic efficiency, wider and less tangible benefits should also be counted.

To the extent the GPS promotes these other objectives (such as environmental objectives) this should be regarded as a public benefit.

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

Transpower agrees that the GPS would have a greater influence on the rules adopted and prioritisation of rules developed under the Crown EGB. Refer to paragraph 77-80.

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

The GPS focuses on executive decision-making by an EGB that is accountable for developing rules which deliver against the GPS. The Industry EGB will develop rules by way of collective industry decision-making risks resulting in anti-competitive outcomes that do not protect consumers' welfare.

31. *Is the Commission's assessment of the rule and decision-making capabilities of the industry relative to the Minister and Crown EGB correct?*

Refer to paragraphs 66-90.

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

Transpower, and other industry participants, are concerned at the lack of competition in the retail market because of generator/retailer integration. For example, there is limited dynamic efficiency as there is no pressure to innovate in a market where there is no scope for new entrants. Under-investment in transmission may also exacerbate problems with "regionalised" retail markets. A further example is the hedge market where an Industry EGB will have little incentive to encourage a more liquid hedge market that might benefit new entrant retailers, but not assist the commercial operations of incumbent generator/retailers.

33. *Would the cost of capital be different in the proposed arrangements relative to the counterfactual?*

Refer to NZIER's submission.

34. *Would regulatory risk affect only the cost of capital for private sector interests?*

Refer to NZIER's submission.

35. *What weight should the Commission give to the potential effects of a Crown EGB on productive and dynamic efficiency in the generation and service provider markets?*

Refer to NZIER's submission.

36. *Would a Crown EGB have a comparative disadvantage in deciding on recommendations to rule changes?*

No - refer to paragraphs 68-90.

37. *If so, would it also have an impact on allocative efficiency in the wholesale electricity market?*

Refer to NZIER's submission.

38. *Would there be higher lobbying costs in the counterfactual? Is the Commission's assessment of this potential cost of an appropriate order of magnitude?*

Refer to paragraphs 85-87.

39. *Would industry input into a Crown EGB's investment decisions provide a restraint on the potential for over-investment and over-maintenance of the grid?*

Refer to paragraphs 91-104.

40. *Is the Commission's assessment of the likelihood of contestable services appropriate?*

Refer to paragraph 105.

41. *Are there examples from other industries of the magnitude of benefits available through making services contestable?*

Transpower has no additional information to provide to the Commission at this point.

42. *Is the Commission's assessment that under a Crown EGB if services were made contestable, it would also allow competitive bypass of service providers correct? If so, would the efficiency gains from that additional competition have a material impact on net benefits?*

Transpower does not wish to comment on the issue of competitive bypass of service providers at this stage.

43. *What scope is there for the proposed arrangements to change over time to remove or lower entry barriers or improve efficiency in the relevant markets?*

Transpower considers that pro-competitive development is highly unlikely for the reasons set out at paragraphs 50-65.

44. *What are the incentives on distributors to vote on reduction or elimination of grid constraints?*

Refer to discussion on transmission investment at paragraphs 100-104. While distributors will have an interest in grid constraints where these impact on security of supply, distributors would have limited or no incentives to remove or reduce grid constraints which only impact on the energy price.

45. *Are distributors likely to have different attitudes to elimination of transmission constraints that have security implications and transmission constraints that lead to higher energy prices?*

Distributors are likely to be affected by the elimination of transmission constraints with security implications and so would be likely to be regarded as beneficiaries of a proposed new investment and have a vote on such an issue. Whether a particular distributor would vote in favour of such an investment would, of course, depend on that distributor's assessment of the costs as against the benefits. Distributors are not likely to be affected by constraints that have no security implications and to the extent these lead to higher energy prices distributors will be indifferent to them. If an attempt was made to impose those costs on distributors they would be likely to vote against the investment.

46. *Quantification of the potential range of detriments indicates that the principal detriments arise from a reduction in competition in the generation markets, and the corresponding weakening in incentives for generators to be efficient. Is the Commission's preliminary assessment that under-investment in the grid would provide strong scope for generators to exercise market power correct?*

Yes. Refer to paragraphs 51-54 in respect of concerns with the current arrangement and paragraphs 100-104in respect of under-investment in the grid.

47. *The Commission's preliminary assessment is that the proposed arrangements are likely to allow generators to increase electricity prices above competitive levels. This would result from both the potential for strike-down of pro-competitive rules and under-investment in transmission. Apart from deadweight losses, are there other public detriments that would arise from an increase in electricity prices?*

Refer to NZIER's submission.

48. *The Commission seeks comment on whether the issues that have been considered in this Draft Determination provide a reasonable summary of the issues of which it should be aware before making a final decision on this Application. The views of interested parties are sought on any additional issues that might be of relevance when considering the benefits or detriments to the public that might result from the proposed arrangements, should they proceed.*

Refer to paragraphs 4-7 in respect of the scope of the application, paragraphs 9-17 in respect of the mandatory/voluntary issue and the cost arising from non-membership which the Commission did not consider, paragraphs 18-21 discussing enforcement through quantum merit and paragraphs 22-23 in relation to comprehensive coverage. Also see NZIER's submission in relation to quantification of these issues.

49. *If the Commission chose to authorise the proposed arrangements, what condition(s) on the authorisation would address concerns about the potential for pro-competitive rule changes not being implemented and any negative downstream effects.*

Refer to paragraphs 108-112.

50. *What would be the benefits and detriments arising from such a condition(s)? Would the imposition of such a condition(s) be consistent with the Act?*

Refer to paragraph 108-112.

51. *Are there any other matters which the Commission could appropriately address with conditions to an authorisation?*

Refer to paragraph 108-112.

52. *Is it appropriate to use a ten year time horizon for the purpose of calculating benefits and detriments?*

Transpower considers it is appropriate to use a ten year horizon for assessing benefits and detriments.

53. *Are the Commission's assumptions on the magnitude of efficiency gains arising from the comparative advantage of industry arrangements relative to the counterfactual appropriate?*

Refer to NZIER's submission.

54. *Are the Commission's estimates of the higher transactions costs in the counterfactual of an appropriate order of magnitude?*

Refer to NZIER's submission.

55. *Are the Commission's assumptions on the potential range of efficiency losses in the counterfactual of an appropriate order of magnitude?*

Refer to NZIER's submission.

56. *The Commission invites comment on its assessment of the magnitude of efficiency losses in the counterfactual relative to the proposed arrangements.*

Refer to NZIER's submission.

57. *The Commission invites comment on its assessment of the likelihood that service providers and system operator roles would be made contestable under the proposed arrangements, relative to the counterfactual.*

Refer to paragraph 105.

58. *The Commission invites comment on its assessment of the potential for price increases, relative to the counterfactual.*

Refer to NZIER's submission.

59. *Are the assumptions on long-run supply and demand elasticities appropriate?*

Refer to NZIER's submission.

60. *The overall detriment resulting from delayed investment is calculated to be $1.5 million NPV, reflecting the low likelihood of a dry winter. Are there any assumptions, which, if varied appropriately, would lead to a significant difference in the result?*

Refer to NZIER's submission.

61. *Is the Commission's assessment of the magnitude of potential efficiency losses arising from a reduction in competitive pressure appropriate?*

Refer to NZIER's submission.

62. *Is the Commission's assessment of the likelihood of under-investment in transmission under the proposed arrangements, relative to the counterfactual, appropriate?*

Refer to NZIER's submission and paragraphs 100-104 of Transpower's submission.

63. *Are there any assumptions which, if varied appropriately, would lead to a significant difference in the calculation of detriments arising from transmission outages?*

Refer to NZIER's submission.

64. *Are there any assumptions which, if varied appropriately, would lead to a significant difference in the calculation of detriments that could arise from inefficient location of new investment?*

Refer to NZIER's submission.