

1 [Hearing commences at 9.00 am]

2
3 **CHAIR:** All right folks, we'll reconvene. I think Meridian were
4 to continue. So, over to you please.
5

6 **PRESENTATION BY MERIDIAN CONTINUED**

7
8 **MR MILLER:** When we left on Thursday we were about to look at
9 Section 5 of the section we put forward to the Commission
10 dealing with conditions. The Commission has asked previous
11 participants about its jurisdiction to accept amendments or
12 impose conditions. The gist of our submission is that the
13 jurisdiction to do so is very wide in either case, and we've
14 referred you to the BCL decision.

15 In this note we set out what we say are the limits on
16 that jurisdiction, and there are three. The first being
17 obviously that conditions have to comply with the -- must be
18 consistent with the purposes of the Act. Second, that they
19 must be consistent with the role of the Commission in relation
20 to authorisations, because the Commission's obviously not in
21 the business of designing optimal arrangements, but rather
22 assessing particular applications, which is pretty obvious.
23 The third is the natural justice issue.

24 The net result of that is that we come to the view that
25 the amendments or proposed conditions that have been signalled
26 at this Conference are available to the Commission as a matter
27 of jurisdiction; we see no natural justice problems with
28 those.

29 Where the Commission might have an issue is in relation
30 to any conditions that have not arisen thus far, and it's
31 clear from what happened in the broadcast communications case
32 that, if the Commission were to impose a condition that was
33 pivotal to the decision to authorise or not, and almost by
34 definition it would be otherwise you wouldn't have the
35 condition, then you'd have to give interested parties an
36 opportunity to comment on it, because that's where the
37 Commission became unstuck in BCL.

38 Now, Meridian for its part has suggested some conditions
39 in relation to Part F. The only other condition that might be
40 considered having regard to some of the issues that the
41 Commission has raised, is granting authorisation for a period
42 which is expressly permitted in terms of s 61. That's
43 something that the Commission might consider doing if it was
44 in a position where it needed to take that step in order to
45 get comfort in relation to some of the issues that are as yet
46 unresolved, and we've pointed to issues such as Part F service
47 definition, pricing methodology and so on. There are others,
48 dispensations, how the application of the quantum meruit rules
49 to non-members will work out.

1 **MS REBSTOCK:** Can I interrupt for just a minute. You've
2 suggested that we might look at a condition that sets a time
3 limit for the authorisation, is that the idea? So we
4 authorise for some specified period, and what would happen at
5 the end of the period?

6 **MR MILLER:** Well, the Act envisages that the authorisation would
7 be for a period so that, if at that time the arrangement
8 continued to raise s 30 issues, then a further application
9 would be needed.

10 **MS REBSTOCK:** It's an interesting concept, but I wonder what your
11 view is about circumstances under which the Commission might
12 be able to do that. It seems likely that we could do that if
13 we thought, during that two year period, we were reasonably
14 confident that the net benefits were going to be secured from
15 the arrangement.

16 I'm not sure -- and I'd be interested in your view --
17 whether we could do it if we weren't sure that the benefits
18 were going to be secured but we thought we could give it a go
19 for a set period and know it would come back.

20 So, I just want to get you to clarify the position on
21 that a little bit for me.

22 **MR MILLER:** I think in order to grant the authorisation you would
23 need to have formed a judgment that its benefits would
24 outweigh its detriments. In other words, of the two scenarios
25 you put, the former is correct in terms of the Act.

26 **MS REBSTOCK:** So what would be the reasoning for only granting a
27 two year authorisation?

28 **MR MILLER:** You have to make a judgment based on the information
29 that's currently before you. There are aspects of this
30 arrangement that are as yet incomplete. You might make that
31 judgment, but nonetheless recognising that things remain to be
32 fleshed out, as it were, set a time constraint on it because
33 otherwise it's indefinite and then the scope of what you are
34 authorising always becomes a little unclear.

35 **MS REBSTOCK:** Does it achieve anything more than the existence of
36 the backstop legislation, which would kick in if at the end of
37 each year the audits by the various parties suggested there
38 was a problem?

39 **MR MILLER:** What it requires -- well, it would in the sense that
40 the Commission's obviously focused on the competition effects
41 of the arrangement, whereas other parties -- including the
42 Minister in deciding whether or not a Crown EGB is called
43 for -- are not necessarily focused on those issues.

44 **MS REBSTOCK:** But the GPS focuses on competition issues, so they
45 must also focus on that when they audit against the GPS. It
46 seems correct that the preview is wider than what ours is, but
47 it does seem to encompass what the Commission itself looks at.
48 Is that fair to say?

49 **MR MILLER:** Yes, that's fair to say. The question then becomes,
50 well, what is the outcome in the event that things don't work

1 out, as the Commission has predicted. And it wouldn't be
2 right I think to assume that a future Government -- and we are
3 about to have a different one of course -- different in the
4 sense that you don't know who the Minister will be for
5 instance. You couldn't predict that the Minister will
6 necessarily invoke that jurisdiction to put in the Crown EGB
7 in circumstances where the Commission would be satisfied that
8 there was a competition problem.

9 **MS BATES:** Of course, if the conditions weren't fulfilled, or the
10 period ended and the Commission weren't satisfied, then you'd
11 have an unauthorised situation.

12 **MR MILLER:** I'm sorry, I was proceeding on the assumption that we
13 didn't have a time period. Obviously you're right.

14 **MS BATES:** Sorry, I might have missed one.

15 **MR MILLER:** So, apart from flagging that possibility, which is
16 something that the Commission could have regard to, then
17 that's all I wanted to say on the subject of conditions.

18 **MR CURTIN:** Just on the conditions you suggested for Part F on
19 prices being non-discriminatory etc, would you care to flesh
20 out a little bit -- the reference in the original
21 submission was paragraph 77 -- where some ideas you had
22 there -- to align the Part F pricing principles to assure
23 alignment with the GPS?

24 **MS BLYTHE:** Can I just check which submission? Do you mean the
25 initial ones in February or in the Draft Determination? Which
26 "77", I guess.

27 **MR CURTIN:** The one dated 23 May.

28 **MS BLYTHE:** Thank you.

29 **MR MILLER:** You are asking what conditions we would --

30 **MR CURTIN:** I was asking you to flesh out what your reasoning
31 was, what problems there were in your view which required
32 addressing by those conditions?

33 **MR MILLER:** We weren't proposing conditions in that paragraph.
34 Rather, we were flagging, I suppose, some limits to Meridian's
35 position. The conditions that we flagged are those that we
36 were talking about the other day, relating to the pricing
37 principles that are applied by the EGB when considering the
38 methodology.

39 If you look at 76 --

40 **MS BLYTHE:** There may be a difference in paragraph numbers
41 between the version Forrie's got in front of him and the one
42 that you have got. My apologies for that.

43 So the 77 that you have got starts, "Given this
44 Meridian...".

45 **MR CURTIN:** Yes.

46 **MR MILLER:** Sorry. Now, can you refresh me on the question?

47 **MR CURTIN:** We've heard your point in general on conditions but
48 you had a fairly specific idea in mind yourself for a
49 condition to amend Part F -- what I read is a set of proposed
50 conditions. I just wondered whether you could flesh out your

1 thinking of what the problems there and how your suggestion
2 met them.

3 **MR MILLER:** We, as we flagged in our original submission, have a
4 serious issue regarding the HVDC pricing, and when we looked
5 at the application the question that we asked was, are these
6 processes, are these rules apt to address that issue squarely.
7 That's the concern that we've addressed both in the initial
8 submission and here.

9 We took a lot of comfort from the Draft Determination in
10 that the Commission said there quite clearly that, in the
11 event there was a problem with inappropriate locational
12 signals or an adverse impact on generators' ability to offer
13 into the spot market resulting from the HVDC pricing, then
14 either EGB would have to deal with it, and based on that
15 moving forward what we were saying is you have to look at the
16 rules that the EGB applies and say, are they apt to allow it
17 to make that decision, and hence we've identified these
18 conditions on the basis that they will secure outcomes that we
19 say are consistent with the goals of the Commerce Act and also
20 the GPS.

21 **MR CURTIN:** Thank you.

22 **CHAIR:** Thanks Mr Miller.

23 **MR MILLER:** S 30: Our position on this is essentially one of
24 agreement with the applicant and with the submissions that
25 were made by Contact, particularly those that were made in the
26 discussions with Mr Dellow.

27 **CHAIR:** Yes, he subsequently gives us opinions, we've got that
28 expanded a wee bit on what he said the other day.

29 **MR MILLER:** So I'm in your hands really how much you want me to
30 address this because, as I say, we're essentially in agreement
31 with that position.

32 **CHAIR:** He's gone into it fairly thoroughly from his perspective,
33 as you know. I think we could just take this as read into the
34 record, thank you.

35 **MR MILLER:** Are there other issues that the Commission wants to
36 raise with us?

37 **MR CURTIN:** I just had one which I mentioned to I think Mr Turner
38 last week, and this is going back quite a bit, but in your
39 very original submission you had some supporting research from
40 Frontier Economics, again on the issue of the HVDC link, which
41 I was hoping you could just refresh all our memories as to
42 what it said and why.

43 **MS BLYTHE:** Thank you. We haven't asked Frontier to join us and
44 partly because, in terms of the Draft Determination, it wasn't
45 an issue that you seemed to be particularly focusing on, so my
46 apologies for not having Phillip Williams with us.

47 Essentially, in terms of Transpower's current pricing
48 methodology and making an assumption that it will be the
49 methodology that will hold going forward, because we have no
50 other information at this stage, the current arrangements for

1 charging for the HVDC link between the two islands is that
2 South Island generators are charged for the full revenue
3 requirement that Transpower wants to recover.

4 That makes a distinction between both the type of
5 network in terms of DC as opposed to the alternating current
6 in the rest of the country, in terms of the different pricing
7 regime; it charges a different set of counter parties for
8 those costs that are wanted to be recovered. In charging
9 South Island generators we see that that's a discrimination in
10 sending a locational signal, just one locational signal to one
11 set of parties in the system. The concept, as I understand
12 it, is that Transpower would argue that South Island
13 generators are beneficiaries from the link.

14 The question when you look, in practise, at the moment
15 about flows, whether they are going north to south or south to
16 north, different parties may benefit at different times. We
17 see that the charging of South Island generators alone is
18 sending a discriminatory signal; it's not sending an
19 economically efficient signal; it's distorting activity in the
20 spot market, and for future investment signals in terms of
21 whether power stations should be located in the north or in
22 the south, and similarly in terms of load, there is no signal
23 provided through the transmission pricing as to where they
24 should locate.

25 **MR CURTIN:** So that, the locational signal is basically --
26 everything else being equal -- a generator would be better off
27 with a new plant in the North Island?

28 **MS BLYTHE:** Yes, we're not saying locational signals are not
29 economically efficient, we're just saying this particular one
30 includes some distortionary components and the way that it's
31 designed, you know, it doesn't send a fair signal.

32 **CHAIR:** Presumably also, there's some load lost because of the
33 distance anyway, load from generators in the South Island to
34 load in the North Island?

35 **MS BLYTHE:** Sure, the losses occur on any link throughout the
36 country just as equally from Taranaki to Auckland as they do
37 from Benmore to Auckland.

38 **CHAIR:** But given you've got twice the distance, the comparative
39 loss is higher, presumably?

40 **MS BLYTHE:** Sure.

41 **CHAIR:** Has Transpower responded at all to any change in that
42 methodology -- without giving away confidential information?

43 **MS BLYTHE:** Transpower has, in terms of trying to operationalise
44 Part F outside the Rulebook to the extent that it's possible,
45 has followed the process of putting forward a draft process
46 for consultation, draft pricing principles, but we're
47 currently waiting for the draft pricing methodology to be
48 released such that parties can make submissions on it. I've
49 seen nothing that indicates that they intend to change how
50 they charge for the HVDC.

1 **MR MILLER:** In terms of the principles that they have identified,
2 the only one that -- as you will see from the Frontier paper
3 that was originally filed -- the only one that might justify a
4 difference is the locational signal, and the point there is
5 essentially you shouldn't give locational signals in relation
6 to one asset; if they are applicable, they must be applicable
7 generally.

8 **MS BLYTHE:** And they should be forward-looking. Whereas the
9 methodology that Transpower has to work within is to recover
10 its revenue requirement; it's not saying about an increment to
11 a particular link.

12 **CHAIR:** Can I come back to another issue that was raised by
13 Mr Turner and certainly was in your submission, the comment
14 that any outcome which, in essence, had other people deciding
15 on issues that affected your asset values would indeed see a
16 Crown EGB as being preferable.

17 Now, would you see a Crown EGB being ably bulletproof
18 from that intervention as well, or such an intervention?

19 **MR MILLER:** There certainly would be issues about whether it was
20 or not. You might be in a position of having to contend that
21 a contract had been frustrated by subsequent legislative
22 activity. You're obviously in a better position to say that
23 in the event that it is a legislative action than you are if
24 it's another contract that's led you to that outcome. But,
25 yes, there are risks around it, definitely.

26 **CHAIR:** But again, you can't make a judgment until you see what
27 the outcome of this application, and people signing up to it
28 is, I guess.

29 I mean one assumes that, if for example this was
30 authorised with conditions or -- just say it was authorised,
31 just for example, then the point Mr Caygill made when he
32 opened up last week or the week before, that voting process
33 would then take place, and of course the viability would
34 depend on who joined up in relation to the total number of
35 people in the industry.

36 So, your decision on the preference to the
37 counterfactual, we would have to see who signed up to the
38 Rulebook under what conditions.

39 **MS BLYTHE:** Our decision in terms of the referendum that David
40 Caygill referred to last week will be on the basis of clearly
41 the Rulebook and any conditions that are put on by the
42 Commission, and in terms of whether the contractual
43 arrangements for the Comalco load are satisfied in terms of
44 the possible amendments. Now, that's a process that's going
45 to be going on through with the applicant.

46 **CHAIR:** It's happening now, as I understand.

47 **MS BLYTHE:** Yes, I'm sort of waiting for what meeting time we
48 need to be having. So, once all that has happened, we will
49 need to make an assessment with the board in terms of whether
50 we want to vote in favour in terms of the referendum.

- 1 **CHAIR:** Because that seems to be the critical point you've
2 raised, I think probably Part F as I read your submission is
3 probably a secondary point by comparison.
- 4 **MS BLYTHE:** Our primary concern at the moment is to ensure our
5 contractual rights in relation to Comalco are not affected,
6 and secondly, some of our concerns in terms of Part F are
7 addressed. Beyond that, I think it would be fair to say we're
8 relatively happy or, you know, accepting of the rest of the
9 Rulebook.
- 10 **CHAIR:** Okay. Thank you.
- 11 **MS REBSTOCK:** Can I just ask you -- and I possibly should
12 remember this, but I don't so I'll ask you -- whether MACQS
13 was considered, did Meridian support the form of MACQS that
14 was actually authorised?
- 15 **MS BLYTHE:** Meridian wasn't, if I remember correctly, in
16 existence when the authorisation was going through, because we
17 were formed in 1 April 1999. We are a member of MACQS and Dr
18 Turner is on the Grid Security Committee.
- 19 **MS REBSTOCK:** Do you have any difficulty with the way MACQS is
20 operating?
- 21 **MS BLYTHE:** Well, it's not operating in the sense of being --
22 it's a governance regime only.
- 23 **MS REBSTOCK:** Sure.
- 24 **MS BLYTHE:** I think there has been a good process in terms of
25 looking at the current quality standards and deriving a
26 baseline. I think there have been a good -- the discussions
27 around the frequency standards and the changing from 45 to 47
28 Hertz. Initially Meridian was not overly attracted to that
29 but over time, and through the discussions of those working
30 processes, has found comfort in that change. So, in that
31 sense we are comfortable with the MACQS arrangements.
- 32 **MS REBSTOCK:** Doesn't MACQS in fact have an impact on the
33 different company's operations and the value of their assets?
34 You said common quality standards, doesn't that have the
35 potential to impact on your assets and your operations?
- 36 **MS BLYTHE:** I think in terms of the first baseline that exists in
37 Part C, if you were to remove the transitional dispensations
38 regime, then there would be quite clearly an impact on assets.
39 Without going into confidential information, you know,
40 Meridian has sought transitional dispensations and I
41 personally am not aware of how many millions it would cost us
42 to have to completely comply with those standards.
- 43 **MS REBSTOCK:** But what I'm asking you is, isn't it the case that
44 the MACQS arrangement potentially does impact on company's
45 operations and asset values?
- 46 **MS BLYTHE:** To the extent that the Part C arrangements that are
47 now the embodiment of MACQS are particularly focused on the
48 ancillary services side of the market, which is a considerably
49 smaller sum of dollars relative to the full spot market, we
50 are comfortable with the voting arrangements in Part C.

1 **MS REBSTOCK:** Because it has a smaller effect on your operations
2 and assets, not because it has no effect?

3 **MS BLYTHE:** Yes.

4 **MS REBSTOCK:** So your objection with respect to imposing
5 conditions that enable consumers to vote on matters affecting
6 operations or the value of your assets, is an objection that's
7 based on the dollar amount that is affected, not whether it's
8 affected?

9 **MS BLYTHE:** That objection was particularly in terms of Part G.

10 **MS REBSTOCK:** In terms of Part G?

11 **MS BLYTHE:** Yes.

12 **CHAIR:** Just to recap what Mr Miller was saying is that long-term
13 contract's ability to be sustained is the critical one in
14 relation to impacting on asset values?

15 **MR MILLER:** I'm picking up here on what was --

16 **CHAIR:** If you look at the submission that Keith Turner made and
17 it was part of your written response to the Draft
18 Determination, you say there unequivocally if there is any
19 impact on asset values the Crown EGB is preferable.

20 I think in discussion it's come to, if the long-term
21 contract with Comalco, for example, was influenced, which one
22 assumes would affect your asset value, that's the prime issue.
23 The others, I think from what you have just said to the
24 Commissioner, are not quite so fundamental?

25 **MR MILLER:** I don't think that is quite how you characterised the
26 submission that if there was any impact on asset values then
27 the Crown EGB would be better. But, you are right, whether it
28 comes to that position, particularly around the Comalco
29 contract, then yes --

30 **CHAIR:** That's the core one?

31 **MR MILLER:** -- that's the core one.

32 **CHAIR:** Thank you very much and thanks for coming back this
33 morning, and also being willing to answer questions and take
34 us through it. So, many thanks.

35 Well, look, we'll adjourn. Transpower will come on at
36 10, so we'll reconvene at 10 o'clock sharp. Thank you.

37 **Adjournment taken from 9.30 am to 9.56 am**

38 **CHAIR:** I think everybody's here. I'd just like to welcome
39 Transpower and thank them for coming in early. Indeed I
40 should, once again, thank most participants for being very
41 flexible about timing to fit in with their needs and the needs
42 of others. So, I hope that you find that, in spite of the
43 change of time, you're able to put your position as thoroughly
44 as you wish.

45 You will know our procedures, I think; we don't get into
46 formal cross-examination, but Commissioners will ask questions
47 as presentations progress, as will the staff. We try and make
48 it as informal as we can and certainly encourage submitters to
49 be as frank with Commissioners as they wish to be.

50 So, Mr Thomson, over to you.

PRESENTATION BY TRANSPOWER

1
2
3 **MR THOMSON:** I'd like to thank the Commission for meeting
4 Transpower and making time available to give this presentation
5 and be questioned on our submission.

6 I will make a relatively high level introductory
7 statement which will set a context for more detailed
8 submissions which will follow from each of my general managers
9 and from our team.

10 I'd like to introduce the team. I've got Nicki
11 Crauford, Dr Nicki Crauford, who's Project Director for
12 financial transmission rights, who's had significant
13 experience in transmission pricing and market design and
14 before that was with Natural Gas Corporation as marketing
15 person.

16 Next to her is Alex Sundakov, Director of NZIER who have
17 done all our independent economic analysis.

18 John Feil, Senior Fellow of the Institute.

19 Elisabeth Welson, partner in Simpson Grierson who
20 prepared our legal positions and Anne Callinan to assist her,
21 another partner from Auckland.

22 Next to me is Peter Robertson, General Manager, Network.
23 He's been our representative on the Government's working group
24 and he's been my alternate on the Electricity Governance
25 Establishment Committee. Been with Transpower nine years,
26 responsible for Network, which is our long-term electrical
27 engineering and market work. Before joining Transpower he was
28 a partner in Ernst & Young.

29 Next to me is Kevin Mackey, General Manager, Operations;
30 35 years experience, the last 15 operating the New Zealand
31 power system. He's my alternate on the Grid Security
32 Committee.

33 Next to him is Bill Heaps, Commercial Services, one of
34 Transpower's two representatives on the Transport Working
35 Group. He's also been instrumental in facilitating and
36 leading the response to the 2001 water shortage -- the 2001
37 winter crisis last year and lining that up for next year.
38 Before joining Transpower he was manager of the Wairakei Power
39 Station for Contact; he was General Manager of Energy Brokers,
40 so he's got a lot of retail experience, and he was also
41 working for Norweb(?) in the UK.

42 Alan Carvell on the end is Corporate Services -- we've
43 got two representatives on the Transport Working Group. He's
44 very familiar with the rules because he's Corporate Services
45 and sees all the financial implications and everything else.

46 By way of background, I have been Chief Executive of
47 Transpower since 1988.

48 In 1987 I was brought in by Mr Ferniho(?) to work on a
49 task force to reorganise NCED to ECNZ. Since that time I've
50 been a member of the WEMDG Committee, the WEMS Committee, I've

Transpower

1 been a board member of M-Co with my Chairman, at the same time
2 prior to this on the board during the establishment of the
3 wholesale market, and latterly I have been a member of EGEC
4 for the last 18 months.

5 I noted when Professor Hogan was talking that there was
6 questions about the role of the Government in establishing the
7 wholesale market. The Government was key to establishing the
8 wholesale market at M-Co. While industry input was
9 significant and essential the Government's objectives were the
10 key driver and MARIA, NZEM and MACQS in their current forms.

11 They did it through the SOEs of ECNZ and Transpower, but
12 I can remember our board being told at that time that one of
13 our key objectives, and you wouldn't find it written down, it
14 was a key objective between the Minister and my Chairman, Doug
15 Ritchie, was to establish the wholesale market, all right.

16 Previous to heading Transpower, I was for 10 years in
17 charge of operations and supply for ECNZ in Dunedin district.
18 That controlled all the major generation in the South Island.
19 I was also district manager after that for two years in
20 Christchurch, which controlled supply in the northern half of
21 the island from Waitaki up.

22 I've got extensive knowledge of the New Zealand power
23 system, both operationally and from a management and security
24 aspect. Having read the draft submission and many of the
25 subsequent submissions made by the parties, it is clear that
26 there is much economic and legal argument and advice to you on
27 making your decision.

28 However, I don't think there is much which identifies my
29 key concerns around the security of the New Zealand power
30 system or the practicalities of what's being proposed to you.
31 The security of the power system is of immense importance and
32 value to New Zealand's social and economic well-being. The
33 decisions or the decision you have been asked to make are
34 important in moving through the steps in the electricity
35 market reform process. Those decisions need to take full
36 account of the importance and value of the security of the
37 power system.

38 I hope we can give you some help in giving you
39 information to arrive at your decisions.

40 Next, the New Zealand Electricity System. The New
41 Zealand power system is quite a fragile system in
42 international terms. The reasons for this are threefold;
43 probably more, but the three main reasons are: It has no links
44 with other major systems as is normal in the United States, or
45 Europe, or even Australia. It's unsupported from an outside
46 environment.

47 Secondly, hydro storage is very limited and as hydro
48 supply's approximately 60% to 70% of New Zealand electricity
49 and the storage in the lakes is approximately 10 to 15 weeks,
50 it has a volatile fuel source. In the future, with the run

1 down of gas reserves taking place, this will become more
2 difficult to cope with because the gas supplies will not be
3 able to respond to sudden demand shifts as well as they can at
4 present. Also, the loads are coming up and as the loads come
5 up the hydro resource becomes more limited as a percentage.

6 Thirdly, it has a fragile transmission system. The
7 transmission system is not gold-plated and never has been.
8 Transpower has always had a policy of upgrading the
9 transmission system where it is needed for security reasons.
10 As well as investing, we grid users agree to bear the costs of
11 investment.

12 I think the Commission should bear in mind that the
13 effects of major outage on the New Zealand economy are large.
14 The supply crisis precipitated by the 1992 water shortage cost
15 1.5% of GDP. The 1998 Auckland distribution outage, a local
16 outage, cost considerable sums of money, in the region of
17 \$300 million. That doesn't take account of the loss of
18 reputation overseas; there was just a complete loss of
19 reputation.

20 Whilst the Draft Determination examined from an economic
21 and competition framework the costs of the various rule-making
22 bodies, it did not take into account all the effects of the
23 changes in decision-making that are going to occur if this
24 proposal is approved. Others will speak specifically about
25 the transfer until responsibility for system security from
26 Transpower under both the proposed Rulebook and the
27 counterfactual and Kevin Mackey will do that.

28 Next I want to come on to management and accountability
29 practices. I'm a practical manager with engineering and
30 accounting qualifications; I'm not an economist and I'm not a
31 lawyer. I have a hard job putting what I think into the terms
32 that you need for your determination.

33 As we pointed out in our submission of 22 May, the
34 industry EGB is a process manager with no decision-making
35 powers regarding the various rules to apply to the industry.
36 The industry sets the policy for security by firstly
37 developing proposals in working groups and then voting on
38 those proposals. There is no clear-cut accountability for
39 this policy setting and there is no single party clearly
40 accountable for the outcomes of these policies.

41 Nominally the industry EGB will have accountability
42 because it will be responsible for adhering to the performance
43 standards and objectives set by the Government under the
44 Government Policy Statement.

45 However, the guiding principles adopted by the applicant
46 depart from the Government Policy Statement. They represent
47 guiding principles and objectives that are acceptable to the
48 industry as the basis for a voluntary agreement. There is
49 every likelihood that over time these guiding principles and
50 the Government policy diverge from one another.

1 **MS REBSTOCK:** Can I interrupt you for just a second.

2 We've had it suggested to us that the Government remains
3 the owner of the vast amount of the electricity industry.
4 Why, in that context, would it tolerate increasing divergence
5 between the guiding principles and Government policy?

6 **MR THOMSON:** Because it doesn't have control -- once you sign up
7 to this contract, you are under the control of a contract. If
8 you are Government owned you're going to have real conflict
9 between any Government policy and the contract, and in my book
10 the contract will win, okay; you've got nowhere to go. Can I
11 come to that later, because I do cover that later?

12 **CHAIR:** Please.

13 **MR THOMSON:** I've had extensive experience with working with
14 guiding principles over the last 15 years, for instance in
15 dealing with the competing arguments over the application of
16 high level transmission pricing principles in developing a
17 pricing methodology. They are subject to much interpretation,
18 word by word. Different parties will have very different
19 views on what high level guiding principles mean at a level of
20 practical implementation.

21 What is more, it is my belief that it is the
22 Government's role to specify the public policy objectives of
23 the electricity industry. We have a democratic process which
24 delegates to Ministers the task of promulgating those public
25 policy objectives. I do not believe it is the right of the
26 electricity industry to set its own public policy terms for
27 what the industry should do, especially when there is no
28 effective representation by the representatives of electricity
29 customers.

30 I believe that in assessing the comparative
31 effectiveness of the applicant's Rulebook and the
32 counterfactual, a Crown EGB will be more effective. It will
33 allow the views of the industry to be considered but by a
34 regulator charged with delivering against public policy
35 outcomes.

36 Transpower currently has responsibility for both setting
37 the system security performance outcomes and standards to
38 achieve these outcomes, and implementing these objectives.
39 Under both, the applicant's Rulebook and the contractual
40 responsibility for implementation will remain, but
41 responsibility for setting performance standards, performance
42 outcomes and the standards to achieve them will be transferred
43 from Transpower.

44 Under the Rulebook this transfer of responsibility is to
45 the industry EGB, but the industry EGB does not have the
46 decision-making powers to take on the responsibility.

47 The lack of clear accountability frameworks for setting
48 outcomes and standards is a dangerous thing to do on the New
49 Zealand electricity system. I can't emphasise that enough.

1 Under the counterfactual, by contrast, the transfer of
2 responsibility is to the Crown's EGB which has decision-making
3 powers aligned to the responsibility it assumes.

4 I want to re-emphasise and make a clear point that in my
5 experience of running the New Zealand electricity system, this
6 lack of clear accountability and lack of cohesion between the
7 policy making and the implementation of running a power system
8 is a major weakness which carries a heavy economic cost.

9 **MS REBSTOCK:** Can we stop for a few questions, Mr Thomson.

10 I just want to go back to this view that was expressed
11 that it's the Government's role to specify the public policy
12 objectives of the industry, and I take it from that that you
13 do not believe that the Government Policy Statement sets those
14 objectives under the proposal?

15 **MR THOMSON:** Not under the proposal. The Government Policy
16 Statement, as given to the Commerce Commission, s 26 or
17 whatever it is, specifies the public policy objectives.

18 **MS REBSTOCK:** But won't the Government Policy Statement be made
19 with respect to the industry proposal?

20 **MR THOMSON:** The industry proposal has got a missing link between
21 the board and the working groups. We'll come to that later.
22 We talk about the Government Policy Statement in our detailed
23 submission, all right, and it's one of the points we cover.

24 **MS REBSTOCK:** Can I just take you back to the comment you made
25 about the wholesale market and your experience in being
26 involved in it and that the Government played a leading role.

27 Part of the discussion we've had here in this room is
28 that, under the proposal, the Minister will continue to play a
29 similar role in terms of providing some constraint around what
30 might happen under the proposal.

31 Couldn't the Government's role in the setting up of a
32 wholesale market actually be support for the notion that the
33 Minister will continue to provide that input as we move
34 forward if this proposal is authorised?

35 **MR THOMSON:** I think the trouble is, the Minister may have
36 influence to the board, all right, talk to the board but the
37 Commission has made the point that the board is sackable by
38 the industry, and there is a missing link. I keep repeating,
39 there's a missing link between the board and the working
40 groups. The board hasn't got the authority; hasn't got
41 control.

42 **MS REBSTOCK:** But, for the board to be sacked, what about the
43 requirements under the proposal?

44 **MR THOMSON:** They just don't get replaced, they're up for renewal
45 every so often.

46 **MS REBSTOCK:** But, how could a coalition be formed to sack the
47 whole board, given the voting structure, with respect to the
48 board appointments? Because my understanding is in respect to
49 that, you do have consumer representation, and it's a bit more

1 dispersed with respect to board appointments than it is with
2 respect to voting on the rule changes.

3 **MR THOMSON:** Anybody works for who pays them; fact of life. Fact
4 of life that anybody works for who pays them, and the people
5 paying the governance board and the industry arrangements are
6 the industry, right? And the Government one, the Government
7 pays them and there's a complete -- anybody -- you've worked
8 in organisations, you work for your boss; sorry. I can't go
9 into all the detailed rules, but I know, I work for my
10 Chairman, right.

11 **MS BATES:** Could I just ask you this. What you said was, on the
12 counterfactual that the power was with the Crown EGB. I have
13 some difficulty with that because, to me, the power's very
14 clearly with the Minister. The Crown EGB has the power to
15 make recommendations and whilst it's true that the Minister
16 has to give transparent reasons if he or she's not going to
17 accept the EGB recommendations, actual accountability would be
18 with the Minister because the Minister makes the decisions.

19 **MR THOMSON:** Look, I'm certain that's in our detailed submission
20 later on, it's covered, but the facts of the matter are --
21 look, I deal with Ministers quite a bit, and Ministers don't
22 make decisions like that. I mean, 14 years, I've seen a lot
23 of Ministers.

24 **MS BATES:** Sure.

25 **MR THOMSON:** And sensible ones very rarely see you on your own,
26 they always want a witness, and they also make decisions after
27 taking advice, right.

28 **MS BATES:** No, I am aware of that. I'm just saying that, if you
29 are looking at the counterfactual as opposed to the industry
30 EGB -- and I take your point about accountability on the
31 industry EGB, because it doesn't have authority -- but neither
32 does the Crown EGB, it doesn't have decision-making power, and
33 I just wanted to put that to you. Though the Minister would
34 be taking recommendations from the Crown EGB, no doubt the
35 Minister would also, when deciding whether to follow that,
36 take advice from officials but at the end of the day it is the
37 Minister that does it.

38 I'm only putting it at this stage because it is a high
39 level theme that's been coming through in this hearing, the
40 concern that the Minister is likely to perhaps listen to
41 Transpower, for example, more than it will listen to the rest
42 of the industry. So, I'll put that on the table right now.

43 **MR THOMSON:** I don't think the Minister listens to Transpower
44 more than the rest of the industry. If you take the
45 generator/retailers, there's four of them. If you take
46 Transpower, that's one. I mean, the present Minister at least
47 is a very good Minister and he understands the industry and he
48 tries to make good decisions; I really think that.

49 **MS BATES:** That's just another thing I wanted to bring up at this
50 stage while we're having the high level discussion, if you

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1 like. As you know, from your long experience, Ministers are
 2 variable in terms of the extent to which they actually want to
 3 have hands-on. Professor Hogan himself was talking about the
 4 legislature and the regulator in the California situation
 5 taking a laissez faire approach and the disaster that arose
 6 from that.

7 The point I'm making is that, there's an inherent
 8 uncertainty, isn't there, with having the power in a Minister
 9 that could change quite radically in terms of policy?

10 **MR THOMSON:** I think there's a fundamental difference. I think a
 11 Minister is responsible to a Government and a Parliament and
 12 Cabinet and in the finish if he doesn't do the right thing he
 13 goes out in the next election, or somebody votes on it. I
 14 think there's a fundamental accountability there.

15 **MS BATES:** Okay, one more question and you might like to answer
 16 it later, but it's another thing that's come up that one of
 17 the themes in this hearing is the divergence between the
 18 guiding principles and the Government Policy Statement.

19 Now, I think I heard you say you were a member of EGEC;
 20 I really want to know how you think this came about. Why do
 21 we have this divergence between the policy statement and the
 22 guiding principles, and what is really the significance of it?

23 **MR THOMSON:** You've got to go back to the guts of EGEC.

24 **MS BATES:** Yes, that's why I'm asking it.

25 **MR THOMSON:** There's been a complete split at EGEC between
 26 Transpower and the consumers on one side and the rest of the
 27 committee on the other, on major issues -- I'm going to cover
 28 that a bit later. But there was a reluctance -- I think the
 29 secretariat and the rest of EGEC believed they could do a
 30 better job of reshaping the Government Policy Statement and
 31 making it more long-enduring than the Government could.
 32 That's my simple answer.

33 I have been close to the Transpower board for a long
 34 time, obviously, right, and sitting on a board, my board
 35 interprets our SCI themselves and the management get queried
 36 very carefully when they go and write in papers that the SCI
 37 means this, and the board actually forms their own view on
 38 that SCI, right. That's why you've got a diversity around our
 39 board table. We've got eight members and they've got a
 40 diversity.

41 What I'm trying to point out at EGEC, that board is
 42 going to have the Government Policy Statement interpreted for
 43 them below them and not going to have control over it, all
 44 right, and I don't think it's right.

45 Anyway, have I answered it?

46 **MS BATES:** What do you see that the major areas of divergence
 47 being, or would you rather answer that later?

48 **MR THOMSON:** I think I'd rather leave it to Peter for later.

49 **MR ROBERTSON:** I could have a crack at it now. There are
 50 specific items that are divergent. For us, I think the most

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1 significant issue in relation to a comparison of a GPS and the
 2 guiding principles lies in the potential for divergence to
 3 emerge over time, and I also sat in on a number of meetings at
 4 EGENC where it was quite clear to me that there's a stark
 5 difference between a majority in the industry and the
 6 Government in respect of the question of accountability.

7 From my observation the majority of the industry, at
 8 least those who had views that were represented at EGENC, are
 9 absolutely adamant that the EGB is not accountable to the
 10 Government. The upshot of that was that the closest the GPS
 11 was able to make it to the proposed arrangements was in the
 12 non-binding forward to the Rules.

13 That is the direct result of this debate that took place
 14 within EGENC as to accountability, and it does seem to me that
 15 in an environment where -- I should say too that position is
 16 entirely consistent, it seems to me, with the sort of
 17 philosophical underpinning of the rules which relies on this
 18 invisible hand; parties acting in their own interests
 19 producing results in aggregate that are in the overall public
 20 interest. That philosophy seems to me quite consistent with
 21 the view that there should be no direct accountability to the
 22 Government.

23 The Government, on the other hand, clearly does intend
 24 to hold the EGB accountable, and so it seems to me you have a
 25 tension between --

26 **MS BATES:** Yes, because the Ministers can set objectives and the
 27 outcomes etc. Do you not see that as being a reasonable
 28 constraint?

29 **MR ROBERTSON:** A reasonable constraint on the industry?

30 **MS BATES:** Yeah.

31 **MR ROBERTSON:** No, I don't because of the subtleties implicit in
 32 the interpretation of the Government Policy Statement. It
 33 seems to me those subtleties are -- you're never going to
 34 escape from those subtleties and in the face of them it's
 35 important that there be, if you like, a positive embrace of
 36 Government wishes rather than a reluctant acknowledgment.

37 If you look at the wording of the foreword to the
 38 proposed rules you will see, I think as far as they go is an
 39 acknowledgment that the Government intends to hold the
 40 industry accountable, and I think that wording was chosen
 41 carefully. And so, I would distinguish between the proposal
 42 and the counterfactual significantly on the grounds that, in
 43 the one you had a reluctant acknowledgment that someone over
 44 there is going to hold us accountable; meanwhile, we think --
 45 that is, the industry under the arrangement -- holds to a view
 46 that pursuing our own objectives we'll deliver.

47 **CHAIR:** In the counterfactual I think you have a more direct and
 48 positive embrace of Government policy.

49 **MS BATES:** Thank you.

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1 **CHAIR:** Just before you resume, Mr Thomson. I think you
2 mentioned Mr Mackey was going to talk in more detail about
3 systems security issues, but as a matter of principle, is it
4 logical to feel that other players in the industry -- the
5 generators in particular -- would have similar objectives for
6 security as Transpower?

7 **MR THOMSON:** No. If you are a proper maximising generator
8 retailer, you want shortage of supply to force the price up.
9 Shortage of supply leads you to security concerns. The
10 transmission system is the base on which an electricity market
11 works; it's a partner with the market. If you haven't got a
12 reliable transmission system, you haven't got a market.

13 Now, I definitely do not think the generator -- and the
14 generators haven't got an overall perspective of what's going
15 on, they haven't got the same concerns about security.

16 **CHAIR:** But to a lay person, and this is where the question's
17 coming from, I mean it's not an informed question, but if you
18 have got to dispatch your load every day of the week, 365 days
19 of the year, you must be concerned that the system will
20 provide the security to do that for you?

21 **MR MACKEY:** I think security fundamentally -- I mean there's a
22 lot of definitional problems around what security means and I
23 think fundamentally security is really the ability of the
24 system to remain stable under certain contingencies and,
25 therefore, the security is about the choice of those
26 contingencies which is really the choice of risk.

27 Clearly if you are down one end of the spectrum you have
28 no redundancy and you have no coverage for risk, which is
29 obviously very cheap and nasty and the costs are quite low.
30 If you are up at the other end of the spectrum, you know,
31 clearly the costs are quite high. I think generators have an
32 incentive to get their costs down and so security effectively
33 is the degree to which you have insurance, the degree to which
34 you provide for contingencies.

35 I mean, individually there seems to be little incentive
36 on individuals to look at security because they look at their
37 own interests, which is only natural. I mean, security is
38 really a collective issue, it's how the system and all the
39 components of it perform together. So it's hard to see how
40 any individual party would come to that conclusion. You need
41 some collective decision-making.

42 **CHAIR:** It's just the objectives in very broad terms, whether you
43 are a generator or the grid operator or both, you must want a
44 system that will basically take your electricity when it's
45 dispatched at a price that's not unreasonable. But surely
46 it's in nobody's interests for the grid to be, A expensive,
47 because of the security situations, or to be inadequate.

48 **MR MACKEY:** I think that at a principle level is right in that
49 the generators' desire to be able to deliver their produce to
50 market. But one could possibly take the analyses of insurance

1 and nobody really wants to pay earthquake and war damage
 2 insurance and that is compelled, people are compelled to do
 3 that, and even I think this recent flooding up in Coromandel,
 4 people obviously didn't have insurance.

5 So, I think there are incentives there to -- I mean,
 6 it's a question of degree. What risks do you cover and what
 7 risks don't you cover? People have different risk appetites
 8 and, therefore, are prepared to take higher and higher risks
 9 and I think that's really the basis of security, what risk do
 10 you take? What risk do you cover? I think sure, I mean you
 11 could have an objective that says well, I would like a
 12 transmission system that will deliver to the market, but I
 13 haven't seen a lot of people coming forward to remove
 14 constraints and what have you in the transmission system.

15 So, I think you are partly right.

16 **CHAIR:** Okay, thank you.

17 **MS REBSTOCK:** Can I just ask one more question? I just want to
 18 tease this one through a little bit.

19 If I understand you correctly your concern is about
 20 mixed accountabilities that the industry EGB would be
 21 accountable to the industry and to the Crown.

22 **MR THOMSON:** No, it's not accountable to the Crown. The way it's
 23 been -- you've got to read the Rules very carefully, it's what
 24 Peter said; it doesn't want to be responsible to the Crown.

25 **MS REBSTOCK:** So your concern isn't about mixed accountabilities,
 26 it's just that the accountability is one way and that's to the
 27 industry?

28 **MR THOMSON:** It is mixed accountabilities. The Government will
 29 be continually pushing that board to adhere to the Government
 30 Policy Statement, and the industry will be continually pushing
 31 back to say, no, I want to do this, which is more profit
 32 maximisation, and there's no clear link in accountability
 33 between the two. I mean, read the Rules; there's no clear
 34 link.

35 **MS REBSTOCK:** Transpower itself must have both commercial
 36 objectives and public policy objectives?

37 **MR THOMSON:** Can I come to that in a minute?

38 **MS REBSTOCK:** Sure.

39 **MR THOMSON:** The next area I want to hand on to was changes which
 40 would be required by Transpower for this proposal to be
 41 satisfactory.

42 As the Commission is aware, Transpower has contributed
 43 extensively to the work to develop the proposal for an
 44 industry EGB and paid 50% of the costs of the development work
 45 undertaken by the applicant. That's in the order of internal
 46 and external costs, it's in the order of \$10 million; probably
 47 a bit more.

48 **MS REBSTOCK:** Is that just Transpower's or the total, the
 49 \$10 million.

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1 **MR THOMSON:** We paid half of the costs of EGEC and paid a lot of
2 internal costs ourselves to do the work on it.

3 **MS REBSTOCK:** So the 10 million is just Transpower's costs?

4 **MR THOMSON:** It's the cost we've incurred. We paid about
5 \$4 million to EGEC, it might be 3. We paid a lot of money
6 into the GSC to keep it running and then our own internal
7 costs on the management on the works, all of that.

8 **MS REBSTOCK:** But that's just Transpower's, it's nobody else's?

9 **MR THOMSON:** No.

10 Either Peter Robertson or I have sat on the
11 establishment committee throughout the process. We have been
12 very frustrated with the lack of appreciation of the points
13 raised by both ourselves and the consumers throughout the
14 process. It has not been a project that has delivered a
15 meaningful consensus. The key elements of the design of the
16 governance of the Rulebook were passed by a majority of EGEC
17 members over the dissenting votes of Transpower and the
18 consumers.

19 Transpower has a culture that emphasises the security
20 and efficiency of the New Zealand power system and markets --
21 this is about the commercial objectives -- both of these are
22 public good objectives which are adhered to within Transpower.
23 They are stated formally in our statement of corporate intent,
24 but just as importantly they reflect a belief that a secure
25 and efficient market will deliver the greatest benefits to
26 this country. As a transmission provider and a system
27 operator owned by the Government, it is very clear that the
28 best outcomes for us and our shareholder are to promote public
29 good.

30 You have heard criticisms of Transpower on various
31 fronts from the applicant and others. I think you should look
32 at our track record in that we are the only part of the
33 electricity industry that's consistently reduced our charges
34 from the separation in 1994 to the present time from something
35 in the order of 1.64 cents to 1.3 cents during that period of
36 time.

37 We have a policy, if we make above WACC, we return it to
38 the customers. We've got very complicated accounts, they are
39 EVA; always neutral. We do not have a commercial objective
40 except to earn our rate of return. Up till now, and you can
41 notice our asset value has come down, our charges have come
42 down; you can notice a complete difference here in the
43 industry to the rest of the incumbents who have put their
44 charges up and their asset values up. All right.

45 **MS REBSTOCK:** Do you think that holds for the state-owned
46 generators as well?

47 **MR THOMSON:** No, they have not got the same statement of
48 corporate intent and they have not got the same side letters
49 from both Governments. We have a letter from Mrs Shipley when
50 she was SOE Minister, and Mr Hodgson knew about that, that

1 said that if our valuation was to drop for efficiency reasons
2 it was to drop, and the shareholder would not mind. I think
3 that's what it says, Pete, and that's why our valuation has
4 dropped as competitive pressures have come on.

5 We may have our deficiencies in terms of being
6 principled and being pretty unforgiving in trying to meet
7 those principles and not compromising. We have worked hard to
8 promote what we believe, from overseas experience and advice,
9 to be an efficient electricity market and an efficient
10 transmission company. Transpower's evaluation of the
11 applicant's proposal and the counterfactual is based on these
12 principles.

13 Transpower believes the principles which need to be
14 satisfied by the proposed governance arrangements are --
15 there's four of them. First one is mandatory compliance with
16 the market rules through effective enforcement. This is
17 necessary to ensure security and quality of supply can be
18 efficiently maintained. Kevin will cover how many people we
19 think have to join, and it's 100%.

20 **MS BATES:** Could I just ask you a question at this point and
21 that's this: We have been told at this hearing that there have
22 been 10 years of under-investment in the National Grid.

23 Do you agree with that assessment?

24 **MR THOMSON:** Can we come to that under investment? We have
25 somebody to speak on investment and that point will be
26 specifically covered.

27 Anything that's said here, I've gone through, all right.

28 Secondly, there should be a means of ensuring
29 consistency of rules across the wholesale physical market.
30 The reason for that is to preserve the essential consistency
31 between the elements of the wholesale physical market. The
32 Rulebook's approach of different classes of voters voting on
33 different parts of an integrated Rulebook is flawed.

34 Thirdly, the governance board should have executive
35 decision-making authority and be truly independent of the
36 interests of the industry. That is to resolve the
37 multilateral issues that arise where consensus decision-making
38 in the public interest is implausible. If you want to hear
39 about the difficulties of that, Nicki Crauford is going to
40 cover financial transmission rights and what's happened in the
41 consultation processes.

42 Fourthly, the guiding principles should be the guiding
43 principles and should be aligned with the Government Policy
44 Statement. If I was running, my board would not allow me to
45 take away the SCI from them; it's what they live by.

46 Given that these principles are not satisfied by the
47 applicant's Rulebook and are likely to be satisfied by a Crown
48 EGB, Transpower cannot support the application for the
49 authorisation.

1 **MS REBSTOCK:** Can I just ask you a question there. Given what
2 you have set out here, that the principles need to be
3 satisfied, can you envision a voluntary industry led
4 governance regime that would meet these?

5 **MR THOMSON:** Speaking from experience in the industry, no; pretty
6 simple.

7 **MS REBSTOCK:** Is it because of the dynamics of this particular
8 industry or is it something inherent to electricity systems?

9 **MR ROBERTSON:** It really relates to the characteristics of the
10 electricity industry, that there are some multilateral issues,
11 the resolution of which inevitably involve perceptions of win
12 and loss, and there needs to be a means of arbitrating those
13 decisions which we don't believe will be forthcoming in a
14 voluntary arrangement.

15 There are certain rules, if you start at the basic level
16 of the physics -- I'm no engineer either, I should add -- but
17 the requirement to match supply and demand in real time or
18 wires will burn, means there are certain rules that have to be
19 complied with.

20 **MS REBSTOCK:** If you had a mandatory regime but it was industry
21 led and met the rest of these criteria, could you envision
22 that working?

23 **MR ROBERTSON:** If it meets all those criteria, yes, we could.

24 **MR THOMSON:** Practically, I mean I've been through transmission
25 pricing for years, been through investment for years; most of
26 the CEO in the industry I call my friends, right; it still
27 doesn't mean I've had major arguments with them that have
28 lasted through long court cases. There's just too much of a
29 diversity and too much pressure on companies to make profit.

30 You can actually see the different behaviour of the
31 generators being privately owned, publicly owned and then
32 being ECNZ -- a far more profit -- putting the commercial
33 objectives ahead of public policy objectives, sorry, if you
34 want to call it.

35 **MS REBSTOCK:** The reason I asked is, you have spent \$10 million
36 trying to find a way to make it work, yet it seems like you
37 are almost saying from the beginning it was doomed. If that's
38 too strong a words to put on it please tell me.

39 **MR THOMSON:** I have asked twice to be allowed to withdraw from
40 the committee. Both times my Chairman and the Minister have
41 told me to stay there, all right.

42 **MR ROBERTSON:** Could I add that we were initially encouraged by
43 the outcome of the inquiry into the electricity industry which
44 recommended a structure that seemed to us to hold the promise
45 for satisfaction of those conditions we've identified here. I
46 think what's rolled out is quite different.

47 **CHAIR:** It's curious though, and maybe we'll pick this up as we
48 work through other speakers, but we've had it put to us by a
49 number of the larger players on the other side -- not all of
50 whom are state owned but the same theme -- that they see the

1 ability to influence a Crown EGB in their view as more of a
2 risk than an industry body under the current proposal ; to be
3 fair, no one has commented yet from the other side as it were
4 on the executive powers on the industry governance board.

5 The point that's made quite strongly is that there seems
6 to be two different perspectives of the ability and substance
7 of what a Crown EGB might be influenced to do. The generators
8 appear to have one view and yourselves and major users, I
9 think, have another.

10 Now, I just find this somewhat idiosyncratic in that
11 objectively everyone's attempting to turn in a reasonable rate
12 of return in relation to their involvement in the industry.

13 I mean, Transpower wouldn't be -- if you ran at a loss for
14 example, you are required to make a return as part of your
15 SCI. So you've got some commercial objectives, surely?

16 **MR THOMSON:** Up till now with no regulation, any lines company
17 could always make their profit. I mean, you might have had a
18 battle with it publicly, but there wasn't much restraint on
19 pricing. Now, it might have changed now with the ODV and
20 price control, but we've -- you can see from our price that we
21 have not tried to raise our prices. I mean, we have not
22 tried -- we are not a profit maximiser, I mean, that's very
23 clear out of our SCI, we have never been a profit maximiser,
24 and that's different to generators, Chairman.

25 I've got two more bits to go.

26 Electricity industry. You are looking at this into the
27 future. The future of the electricity industry is driven by
28 technological change, and if you look back 10 years it's been
29 driven by technological change in the last 10 years. The
30 major shift that occurred in electricity was combined cycle
31 GTs and IT advances, information technology advances.

32 Technological change is usually not to the commercial
33 advantage of incumbents in the industry as it will lower the
34 costs of new entry. In the case of electricity, the threat to
35 incumbents is from such things as renewables and small-scale
36 generation. These are appearing on the horizon, but with the
37 self-interest of the industry being the key driver behind the
38 applicant's proposals these technologies will not be
39 incorporated in this country as quickly as they would be with
40 a regulatory structure that satisfies the principles I
41 described previously.

42 In conclusion I think you should know that as Chief
43 Executive of Transpower I could not recommend to my board that
44 they sign up to this multilateral contract. The board has
45 been involved in the preparation of Transpower's submissions
46 to the Commission and is squarely behind Transpower's
47 opposition to the application.

48 However, it is clear that there -- and this is not just
49 supposition -- it is clear that there may be circumstances
50 where the Crown may feel strongly enough to direct the company

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1 to go along with what is being proposed. I am quite
 2 convinced, having sat through many hours of debate, that the
 3 dominant position of the generator/retailers in this country
 4 at the present time will mean that these rules, if they are
 5 approved, will lead to less competitive and less efficient
 6 outcomes and further reinforcement of the market domination by
 7 generator/retailers in this country. This will clearly be
 8 detrimental to New Zealand's electricity consumers and to the
 9 economy at large.

10 I'd like to thank you for listening to me.

11 **CHAIR:** Thanks for your submission.

12 **MS BATES:** Could I just ask you a couple of questions from the
 13 final bit. That is, we are told by the applicant that the
 14 Minister -- this Minister -- prefers an industry EGB to a
 15 Crown EGB. Do you agree with that supposition?

16 **MR THOMSON:** I agree with the supposition that he says that he
 17 wants as little regulation as necessary and as much as it is
 18 necessary, all right.

19 **MS BATES:** But do you accept that he has expressed a preference
 20 for an industry led EGB?

21 **MR THOMSON:** He has said to me that in the end one option may be
 22 that Transpower gets its governance changed.

23 **MS BATES:** Gets its?

24 **MR THOMSON:** Governance changed.

25 **MS BATES:** Yes, what do you mean by that?

26 **MR THOMSON:** Well, that's all he said to me. I know what I took
 27 out of that. That's pretty strong stuff.

28 **MS BATES:** Does that mean that you may be directed to join
 29 whether you --?

30 **MR THOMSON:** No, it's a bit more than that. Transpower has
 31 always been a funny SOE, because it is not completely -- it is
 32 not commercially driven; it's a value enhancer for the
 33 industry, not a profit maximiser for itself.

34 It was put into an SOE because that was the easiest way
 35 to get it separated.

36 **MS BATES:** So, do you think its objectives may change?

37 **MR THOMSON:** Yes. No, it isn't the only objective. When they
 38 say governance they're talking about whether it's a Crown
 39 company or it's an SOE. Because you've got more control over
 40 a Crown company.

41 **CHAIR:** Yes, quite a different model from a company constitution
 42 point of view.

43 **MR THOMSON:** I've checked that with other parts -- we're in a
 44 public place -- I've checked that with other senior people,
 45 and I've been told it will almost certainly stay an SOE, but
 46 times change.

47 **MS BATES:** The other question, final question from me on this
 48 part is, one of the principles which you are looking for in
 49 governance is the governance board should have executive
 50 making authority and be truly independent of the interests of

Transpower

1 the industry. Can I just explore that a bit more? Do you
2 mean you would expect a board appointed by the Minister?

3 **MR THOMSON:** I don't think you have to have --

4 **MS BATES:** It's just that earlier you were talking about --

5 **MR THOMSON:** I think the board that's proposed in the Government
6 Policy Statement have the majority of independence and the
7 possibility of some industry people -- a minority of industry
8 people with the independence being consumer focused and having
9 certain qualifications, is better than what the industry has
10 proposed.

11 **MS BATES:** I suppose I was looking at the hiring and firing
12 really.

13 **MR THOMSON:** I support a Government EGB, putting it simply. All
14 right; that answers the question does it?

15 In the Transpower board I've never found -- we've always
16 had a very strong board, very good directors, and we've had no
17 trouble with Ministerial selection or anything like that.

18 **MS BATES:** If you did have a Government EGB, do you think you
19 would be able to get the level of expertise on to that board
20 that is required?

21 **MR THOMSON:** I think you'd get a better board. Look, I'm
22 retiring in 10 months, okay, I'm prime candidate for the EGB.
23 Wouldn't touch it. I've got too much responsibility and not
24 enough accountability. Wouldn't touch it, and you're going to
25 find a lot of people like me.

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

27 **CHAIR:** Just another question which you may want to give a bit of
28 thought to.

29 It was said by the applicant, I think, that the sort of
30 central point in all this argument is security versus risk, a
31 point I think Mr Mackey raised, and I'd be interested in a
32 view perhaps when he's making his presentation, as to how the
33 Commission ought to try and make an informed judgment on those
34 two issues.

35 I think you were explaining that a minute ago anyway,
36 but you may want to expand on that a little when you make your
37 presentation, because that's been coming through very strongly
38 in behind most of the presentations I think, and I suppose for
39 reasons some people would say innovation, others will say
40 risk. So Mr Mackey if you can try and quantify that from your
41 point of view a little more when you are speaking.

42 **MS REBSTOCK:** Can I just ask one more question? Is your concern
43 primarily with Part F? Do you think the rest of the Rulebook
44 is authorisable?

45 **MR THOMSON:** No. No, not just for Part F.

46 **MS REBSTOCK:** So it's for the whole of the arrangement?

47 **MR THOMSON:** You've got Part C set up for everybody joining and
48 it was specifically set up for that. You've got dispatch over
49 in Part G or H or somewhere, which should be in with the

1 common quality, and that was argued very thoroughly at EGEC.
2 No, I'm not happy with the Rulebook; sorry, Commissioner.

3 **MS REBSTOCK:** So does that mean that you are not happy with the
4 operation of the current rules? Aside from the issues around
5 transmission?

6 **MR THOMSON:** In my opinion the current rules are not that good,
7 but they're better than the industry EGB, right. And I get a
8 lot of advice, okay -- I mean, I've got Hogan writing me
9 letters and I've just been to a Conference in the UK for a
10 private one with all the 60 people from tops of the grid
11 around the world about what's going on in the markets, and I
12 form my own opinion, but I get advice. That's where I am.
13 This team, I don't go anywhere without them. Sorry.

14 **CHAIR:** Okay, thanks Mr Thomson. Who's next?

15 **MS CALLINAN:** Mr Chairman, my name is Anne Callinan, I'm from
16 Simpson Grierson and I'd just like to make some brief
17 introductory remarks in relation to the way the submissions
18 hopefully will flow today. I'm here with Elizabeth Welson
19 who's a partner of mine at Simpson Grierson and I'd like to
20 formally thank the Commission for granting Transpower the
21 adjournment that we sought due to Elizabeth being unwell.
22 She's only just rejoined us today and we are happy that she
23 could make it on to the panel.

24 **CHAIR:** I think we have a few of the halt and the lame here
25 today, but let's get on the best we can.

26 **MS CALLINAN:** Hopefully we'll make it through the day.

27 I'm conscious of the fact that we're speaking at the
28 tail end of the Conference and the Commission has heard a
29 wealth of information already, received detailed submissions
30 from Transpower, and heard from Professor Hogan.

31 So the purpose of the oral submissions today is not to
32 cover all that ground. We have three objectives. The first
33 is to impress upon you what we consider to be the main points
34 in our submissions. The second objective is to respond to
35 some of the points that the applicant has made where we
36 consider that is appropriate and necessary.

37 The third objective -- the most important objective
38 really -- is to facilitate the type of interchange that you
39 have already had through questions with the Transpower
40 executives and it's for that reason that we've deliberately
41 assembled almost every member of the Transpower executive
42 today to help that question and answer process.

43 I will just briefly outline the topics that we want to
44 cover; they are set out in the table of contents to the
45 submission just to identify them briefly and the order in
46 which we propose to deal with them.

47 We'd like to deal with decision-making first, then pro-
48 competitive rules, the possibility of anti-competitive rule
49 changes third, then transaction compliance and lobbying
50 costs -- and you will note as you go through that we've

1 assigned various people to speak to these topics, either
2 ourselves, NZIER or representative Transpower.

3 Then we're going to deal with the price risk of under-
4 investment in the transmission grid and pick up on some of
5 those questions you have already asked, constraints against
6 over-investment, competition and transmission services,
7 contestability of service provision, comprehensive coverage,
8 the GPS -- although we've already had some discussion on
9 that -- cost of capital, the scope of the authorisation,
10 guidelines, conditions and finally Alex Sundakov will really
11 sum up by pulling all those points into NZIER's analysis of
12 the benefits and the detriments.

13 I just want to start myself by making a few points
14 because there's 15 topics that we want to cover today and with
15 the time we've got tomorrow, but there are three in our
16 submission that are going to make a difference.

17 The first of those issues is the comparative advantage
18 in decision-making between the arrangement and the
19 counterfactual. In the Commission's Draft Determination a
20 significant value was attributed to the benefits of decision-
21 making under the industry EGB. Transpower's submission is
22 that there is going to be no significant difference in the
23 quality of decision-making under the Crown EGB and the
24 industry EGB. If anything, the Crown EGB in Transpower's
25 submission will yield better quality decisions and we'll
26 explain why we think that's the case.

27 The second major area, of course, is the strike-down of
28 pro-competitive rules. Transpower endorses the fact that the
29 Commission has recognised this as a significant risk, and in
30 our submission the applicant has not submitted any serious
31 arguments to counteract that risk.

32 This one point is so significant in itself that, all
33 things being equal, that should alone be the deciding factor
34 in whether this proposal is authorised in our submission.

35 The third key area is that of investment, under and
36 over-investment. Transpower agrees with the Commission's
37 Draft Determination that there is a risk of under-investment
38 and says that the applicant has been unable to meet this
39 issue. We submit that the Commission's concerns that the
40 Crown EGB may over-invest is misplaced, and we'll deal with
41 that in our submission today.

42 That's really all I have to say by way of introductory
43 remarks. We thought it would be useful at this point to have
44 NZIER give some high level comments on the economic issues
45 that are central to this application.

46 **MS BATES:** Could I just make one point when we're talking about
47 under and over-investment? It seems to me that there are two
48 issues about that and they are related, and that's security
49 and capacity. Do you follow me?

50 **MS CALLINAN:** Yes.

1 **MS BATES:** I'd just like you to address each of them, if you
2 like.

3 **MS CALLINAN:** Would you like me to do that now or wait till we
4 get to the topic?

5 **MS BATES:** No, tell me as you go through because to date we
6 haven't necessarily distinguished between the two, or where
7 there is a link up between the two, and that may be an issue
8 of significance.

9 **MS CALLINAN:** We'll ask Kevin Mackey to address that when we get
10 to that topic.

11 **DR SUNDAKOV:** What I'd like to do at the start is just go through
12 at a relatively high level and compare and contrast the key
13 elements of the proposal in the counterfactual. The things
14 that we think are really essential to identifying the
15 differences between the two.

16 I should start by emphasising that comparisons of
17 regulatory regimes are exceptionally complex and very subtle,
18 and I think it's very difficult to arrive at always very clear
19 distinctions. They require very careful analysis of realistic
20 institutional settings with all the subtleties, all the
21 unspoken elements as well as clearly established rules that
22 exist in the way that institutions operate.

23 In particular I think it's important in understanding
24 the role of Government. I mean, clearly Governments operate
25 explicitly, they also operate implicitly from understandings
26 of what Governments expect of people. People make decisions
27 and participate in processes in ways that are not always
28 easily explained by the way the outside forms of the
29 regulatory processes will suggest.

30 So I think that what's very important is to avoid
31 caricatures, avoid looking at a Crown EGB as some sort of
32 central planning process, or avoid looking at the industry EGB
33 as a kind of a pure market expression of pure market
34 efficiency, and rather look at what is it that makes it so
35 different at a realistic level.

36 Last time that I spoke to the Commission on the question
37 of choosing between regulation and self-regulation was in the
38 context of the Number Portability Deed when I gave in evidence
39 support of the number portability deed in support of self-
40 regulation, and I think that that's a useful starting point
41 for considering the industry EGB proposal. Because it's quite
42 interesting to identify what is it that's different between
43 the number portability deed and the industry EGB. Why is it
44 in my previous evidence I spoke in support of self-regulation
45 whereas here I think on balance self-regulation is unlikely to
46 work -- unlikely to be as efficient as Government regulation
47 in this particular case.

48 As you would recall, the number portability deed had a
49 number of very specific features which I think fitted the

1 requirements for when self-regulation is likely to be more
2 efficient than central regulation.

3 First, it didn't deal with governance issues in the
4 sense that the Number Portability Deed didn't allow the
5 industry club to keep evolving the Rules beyond what was set
6 at the beginning. The Number Portability Deed was about a
7 finding a way to administer a predetermined process. The
8 suggestion was that the industry had a greater incentive than
9 the Government to find the least cost way of administering a
10 predetermined set of rules and procedures.

11 I think that that's quite different to what is being
12 discussed here, where clearly the key elements of the industry
13 EGB proposal is the capacity for the club that's being created
14 to keep evolving the governance rules of the time.

15 I think also you would recall that the number
16 portability deed went into some length in trying to protect
17 the interests of new entrants. It wasn't a process that
18 focused on the interaction among incumbents but rather was a
19 process that, right at the start in the way the authorisation
20 was sought, sought to interpose the interests of new entrants
21 and incumbents. Again, that seems to me to be an important
22 contrast.

23 **MS REBSTOCK:** Can I just -- because I'll forget if I don't
24 interrupt and ask you. On the first point about this process
25 allowing the Rules to continue to be developed, I wonder about
26 that because the Commission has indicated that it would be
27 looking at authorising specific proposals, and if the Rules
28 changed in the future in a way that wasn't consistent with
29 what was authorised, they would have to come back. In fact in
30 the number portability work it was a similar thing, it was
31 getting together to come up with an approach, but the actual
32 approach was going to have to come back once it was developed.

33 So, I know that Transpower has questioned whether we are
34 authorising specific proposals or basically the whole of the
35 Rulebook, but to the extent that we're actually looking at
36 specified proposals I wonder if that's really a correct
37 statement to say that the authorisation in this case would
38 necessarily allow the Rules to be changed through time without
39 them ever coming back?

40 **DR SUNDAKOV:** I think, as you said, that the issue is precisely
41 that; that's the scope of authorisation.

42 It seems to me that evolution in rules is likely to
43 involve a reasonable amount of changes. As I understand
44 something like 19 rule changes in the last five years in the
45 UK, I think there's something like 100 rule changes happening
46 every year. There's clearly going to be a significant and
47 complex choice that would need to be made at what stage these
48 rule changes are within the scope of what's authorised, and
49 what stage one has to come back to the Commission for further
50 authorisation.

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1 Clearly the Commission has no capacity for 100
2 conferences per year to deal with every rule change, and the
3 question is just how wide is the scope for the rule changes to
4 continue without coming back to the Commission. I think you
5 are absolutely right, one can envisage very very significant
6 changes -- say changes to voting allocation, that clearly
7 would bring the industry EGB back to the Commission.

8 But one can easily also imagine fairly subtle evolution
9 which can have quite significant downstream effects that would
10 proceed without coming back to the Commission. I think it is
11 different to what was envisaged under the number portability
12 deed simply because the deed dealt with a very narrow issue;
13 the applicants had to go through a predetermined process of
14 going through the cost-benefit analysis.

15 Once that was completed, there was then a relatively
16 predetermined process, although somewhat more open, for
17 deciding on pricing and then had to come back to the
18 Commission for ruling on the final pricing decision.

19 So I think that it's that that makes it very different.

20 In essence, as I said before, the issue under the number
21 portability deed was to find the least cost way of managing
22 the process. Whereas the issue under the EGB I would
23 characterise as being essentially about the allocation of
24 costs and benefits between members of the club the and the
25 outsiders, people who are within the industry club and those
26 had who are outside the club which is essentially consumers
27 and new entrants. That, I think, is very different and the
28 key problem that I'd like to address is precisely how these
29 outside interests are likely to be reflected.

30 I should say at the start that clearly consumers will
31 have a degree of formal voice within the industry process. I
32 think though that we would expect that voice to be
33 significantly less powerful than the voice of industry
34 interests, as I think is common experience in similar regimes,
35 not just in the electricity sector but other regimes that
36 involve consumer representation around the world or other
37 sectors in the New Zealand economy, largely because consumers
38 tend to be relatively less resourced, their interests are much
39 more dispersed, and while there are occasionally some large
40 consumers who have sufficient resource to get engaged, what
41 often happens is that large consumers get bought off in a
42 sense and the dispersed group of small consumers find it very
43 difficult to express their voice.

44 **CHAIR:** I just want to ask you a question. We haven't heard from
45 the CC 93 group per se, but I think submissions made by MEUG
46 picked up some of the issues that presumably they will raise
47 when they make their formal submission. But given that you
48 have got a number of major consumers reasonably well
49 resourced, do you think that at least brings some balance into

1 the ability of consumer interests to have their point debated
2 and heard or researched and heard?

3 **DR SUNDAKOV:** I think that you're absolutely right, it brings
4 some balance back. I think though what I would emphasise is
5 the fact that there is still quite a significant disparity in
6 just how concentrated the interests are, but I think more
7 importantly it is likely that, to the extent that the
8 interests of large consumers diverge from interests of small
9 consumers, solutions can be found where the club makes
10 decisions which excludes the interests of smaller consumers
11 who essentially find it very difficult to participate in this
12 process.

13 **MS BATES:** You have heard me ask Mr Thomson about the power of
14 the Minister in all of this and I'm going to ask you the same
15 because it seems under the legislation the Minister has
16 reserved a, what could be described as a fairly significant
17 monitoring role.

18 Now, given that the Government Policy Statement f
19 essentially seems to give more weight to the interests of
20 those who you describe as being "outside the club", do you not
21 think that the Minister could provide an effective constraint
22 upon those objectives not being met?

23 **DR SUNDAKOV:** Something that I'd like to come to in some detail a
24 bit later, but just to pre-empt what I was going to say;
25 there's no doubt that there's going to be a role for the
26 Government under the industry EGB and the Crown EGB. The
27 question is how is this role going to be exercised and it
28 seems to me that the distinction lies in the Government being
29 in, very explicitly in one process, versus the Government kind
30 of hovering above another process, standing by to helicopter
31 in when it perceives problems.

32 **MS BATES:** Well, no it's not quite the "helicopter in when it
33 perceives problems". If you've got a Minister which is
34 actually setting objectives and outcomes it's not quite the
35 same thing, is it? I mean, there's specific objectives to be
36 achieved, it's not just standing back and saying "look okay
37 we'll go in and do something if it starts to go wrong".

38 **DR SUNDAKOV:** I think the question is exactly what is an industry
39 EGB? If we're saying that this is an example of self-
40 regulation where the Government isn't going to be involved
41 boots and all on a daily basis and some of the benefits that
42 are being claimed for for this process are specifically about
43 the Government not needing to invest a considerable amount of
44 resource in understanding the minutiae of what's going on,
45 understanding every detail of what's going on, then I think it
46 is helicoptering in because there is no other option.

47 The alternative I think that you are suggesting is that
48 the Government will take a very hands-on role, that it will
49 monitor specific developments, you know, every individual
50 development taking place. It will try to invest resource in

1 understanding the subtleties of every minor rule change that
 2 may be taking place, the sort of rule changes that don't
 3 involve going back to the Commerce Commission, but nonetheless
 4 may alter things. It will monitor outcomes and processes.

5 I think that kind of Government that will be able to
 6 achieve that level of involvement to my mind begins to merge
 7 into being a Crown EGB. I think in some sense that the line
 8 separating the two might not be all that great. It seems to
 9 me the more you describe a useful role for the Government
 10 under an industry EGB, the more you describe a Crown EGB
 11 outcome.

12 **MS BATES:** I'm just saying, the framework is there; it's not just
 13 a club going off in its own direction necessarily, and I also
 14 wanted to ask you about this use of the word "club" because --
 15 I'm not disputing that you can say it, but it has a sort of
 16 flavour about it, if you like.

17 So, do you see the industry EGB as being part of that
 18 club? Do you see it as being just part of the industry, an
 19 industry-based club? You don't see it as representative in
 20 any way of the interests which the Government has sought to
 21 protect, if you like?

22 **DR SUNDAKOV:** An industry EGB that is essentially a process
 23 organisation where all the key decisions go back to the
 24 industry vote; has to be a club. My friend here suggested to
 25 use the word "club" in reference to the word "cartel" -- I'm
 26 not suggesting that's what we're talking about.

27 But I think, you know, the essence of this is that, to
 28 the extent that there is any tension between the industry EGB
 29 and the Government, it has to be the tension between the
 30 Government representing a broader public interest and the
 31 industry representing a club interest. I don't think there's
 32 anything wrong with it, I mean, that's precisely why people
 33 get together, is because they want to represent the interests
 34 of their club.

35 **MS REBSTOCK:** Let's pursue this notion of a "club" or, as your
 36 colleague suggested "cartel" because in effect that's almost
 37 what's being suggested.

38 Getting beyond the issue about the proposal versus the
 39 counterfactual. I mean, for there to be some club or cartel
 40 behaviour there must be market power somewhere, and I'm sure
 41 that you're aware that in the past we looked at the retail
 42 market and came to the view that there was sufficient
 43 competition that we had a national market and we had a
 44 competitive market. The generation side has been broken up
 45 into a number of players, some with at least -- the majority
 46 of it may be state owned, but they're still separate
 47 companies. So there's some competitive pressure in there.

48 It seems to me, to get the sort of behaviour that you
 49 are concerned about, you must be assuming that that

1 competitive pressure in the generation retail arms is not
2 sufficient, there's not sufficient constraint created by it.

3 Is that your assessment of these markets?

4 **DR SUNDAKOV:** I think there are two elements to this. The first
5 is the degree of competition that you find today, and there's
6 no doubt that there is a significant degree of competition in
7 this market. The question is, market power and degree of
8 competition in the sense as a continuum, is this on the
9 continuum where you would say that no market power issues
10 exist? I think the answer would have to be, no, that there
11 are clearly some contacts where market powers do exist in this
12 industry.

13 Equally important I think is not just the question of
14 what we observe today but the extent to which the operation of
15 a club may be used to enhance market power into the future.

16 **MS REBSTOCK:** So your thesis is that the Rulebook, if authorised,
17 will enhance the cases of market power, particularly at the
18 retail and generation level?

19 **DR SUNDAKOV:** I think it clearly creates the potential for doing
20 this. With any regulatory environment, whether the potential
21 be realised or not, is difficult to predict, but I think
22 there's no doubt that the potential is there.

23 **MS REBSTOCK:** Your view is right now that generally these markets
24 are reasonably competitive.

25 **DR SUNDAKOV:** They are reasonably competitive but certainly not
26 perfectly competitive. I think this is a market where some
27 degree of market power is almost essential. In a perfectly
28 competitive market, prices for energy would always extend to
29 short-run marginal costs. Short-run marginal costs you would
30 never justify an investment. So it's a market which over time
31 needs to have periods of prices significantly run above short-
32 run marginal costs, so it's a market that can't entirely avoid
33 elements of market power.

34 **CHAIR:** You make that point quite strongly in your written
35 submission about trying to get long run marginal cost in
36 relation to investment.

37 **DR SUNDAKOV:** Let me get back. In a sense the questions you are
38 raising go directly to what I was planning to say anyway, but
39 if I may just very quickly run through the key elements.

40 It seems to me that in comparing the proposal in the
41 counterfactual we need to address four essential issues, four
42 essential questions. The first one is how the externality is
43 dealt with. Externalities in the sense of impact on third
44 parties.

45 The second one, how does self-interest operate under
46 these circumstances? Self-interest is pervasive, self-
47 interest is what drives the economy, but the question is, how
48 does self-interest operate under these particular
49 circumstances as a way of -- or does it operate as a way of
50 deriving the common good?

1 The third issue is, what are the key determinates of the
2 quality of decision-making in comparing the counterfactual and
3 the proposal.

4 The final point, the one we started discussing, is how
5 does the Government fit into this process? I'll come back to
6 that in a little more detail.

7 Let me start by looking at the externalities, because I
8 think that's probably the key issue here and very much lays
9 the foundation for the rest of my thinking.

10 The applicant I think says two things essentially about
11 externalities. The first one is that externalities in this
12 case will be resolved through pre-contracting. So, in other
13 words, there are investment decisions or process decisions
14 which impose costs and benefits on parties that go beyond just
15 the immediate contract and the question is how to ensure that
16 these get captured.

17 What the application says is that these get captured
18 through the pre-contracting that sits in the Rulebook. So, by
19 virtue of forming the Rulebook, and the voting processes which
20 underpin the Rulebook, that is a way of resolving the
21 externalities.

22 I think that that's largely right, I think that that's a
23 correct description of the externalities that exist between
24 different industry participants. So, to the extent that there
25 is a common investment which one of the parties may free ride
26 on, there are certainly some elements of the Rulebook that
27 will allow that externality to be resolved by forcing the cost
28 of that back on to the party that would benefit from it.

29 So I think it does go certainly some way towards
30 resolving the externalities, but not all the way, and the
31 critical problem to my mind, and the problem that doesn't even
32 get addressed in the application, is the externalities that
33 get imposed on outsiders to the club, externalities that get
34 imposed on consumers or on new entrants. In other words, the
35 pre-contracting that's inherent in the Rulebook by resolving
36 some externalities actually creates an environment where
37 further and possibly even greater externalities can be imposed
38 on parties that are outside the process.

39 I think that the fact that these are not addressed is
40 the most critical concern I think that underpins this.

41 **MR CURTIN:** I wonder if you could give us some practical examples
42 of where you might see that played out?

43 **DR SUNDAKOV:** I'll come back, for example, to the question of
44 system security and it's something in my notes I have coming
45 back a little bit later, but I think it's relevant here as
46 well and it relates back to self-interest.

47 In the absence of a liability regime that makes industry
48 participants liable for all subsequent costs of load
49 interruption, the loss to industry participants from load
50 interruption is the loss of revenue. That is different to the

1 loss that may be incurred by customers, and in fact the loss
2 that will be incurred by customers is likely to be greater
3 than the loss that would be incurred by industry participants.

4 So, what you would expect is that industry participants
5 would have a greater incentive than the outsiders to the
6 process of taking greater risks. That's not to say that they
7 don't care about delivery, but in terms of the trade-off that
8 exists between how much you invest in avoidance of loss and
9 how much risk are you willing to tolerate, it seems to me that
10 industry participants would have a greater interest in taking
11 that risk compared to the outsiders, compared to customers.

12 So, to the extent the industry club resolves the
13 conflicts that may exist -- conflicts of interests that may
14 exist between members of the club, it may in fact concentrate
15 these interests to the detriment of those who may be outside
16 the club.

17 **MR CURTIN:** I understand your point. That presumably exists as a
18 general point irrespective of the existence of a Rulebook or
19 otherwise.

20 **DR SUNDAKOV:** I think that's absolutely right. The question
21 though is, we're comparing the Rulebook and the
22 counterfactual. The counterfactual is a Crown EGB which is
23 likely to be a lot more sensitive to the outsiders' concerns,
24 if nothing else. Dispersed customers tend to produce a lot of
25 votes.

26 But I think also an important element in resolving
27 externalities is the degree of compulsion that exist in the
28 system. The application essentially says that particularly
29 with respect to transmission investment, but also with regard
30 to other common services, effective compulsion exist. It
31 exists either through membership, so if you become a member
32 you will be compelled to participate in common good activities
33 or it exists through quantum meruit and I'm sure my legal
34 colleagues will address quantum meruit in more detail.

35 It seems here again in comparing the proposal
36 counterfactual you've got to consider what is likely. Either
37 this effective compulsion does exist, in other words, that
38 yes, indeed either through membership or through quantum
39 meruit the Rulebook is able to bring everybody into the
40 process, but then I can't see how one can claim the benefits
41 of being voluntary and open to alternatives.

42 Or, alternatively you are saying well, no actually
43 alternatives can exist. There are other options, other things
44 that can happen outside the single process, but then it seems
45 to me one runs the risk of externalities not being resolved
46 because of this lack of compulsion.

47 I think it's important to decide exactly what's going to
48 happen here, but to the extent that it is possible to act
49 outside the Rulebook, then I think one would have to say that

1 compulsion that is necessary to resolve all the externalities
2 does not exist.

3 Let me move on to the question of self-interest, and
4 that's related to the question of externalities I raised. The
5 application says that industry member self-industry is in
6 having an efficient and competitive market. I think that's a
7 somewhat unrealistic interpretation of how most businesses
8 operate. Industry members' interest, unless they have very
9 very special statements of corporate intent that tell them to
10 do something different, but under normal corporate kind of
11 interest, the interest members' interest is in profit.

12 Now, there are many circumstances where a profit and
13 market efficiency coincide. But there are also lots of
14 circumstances where they don't coincide and in particular they
15 don't coincide where costs and risks can be passed on to those
16 outside the industry. So to the extent that costs and risks
17 can be passed on to those outside the risks, the profit
18 incentive is not the same as the efficiency incentive.

19 **MS REBSTOCK:** But this industry is reasonably competitive at the
20 generation/retail levels, wouldn't you expect it to coincide?

21 I mean, this doesn't seem to attract the huge interest
22 of the network companies in the same way. Transpower is
23 arguably in a strong monopoly position, but if the other
24 players are in competitive markets, where is it that the
25 condition arises for concern about the profit motive not
26 advancing efficient markets?

27 **DR SUNDAKOV:** To the extent that the operation of -- well, let's
28 imagine a rule change which reduces efficiency by increasing
29 barriers to entry for new entrants into the industry. Would
30 you say that that's a rule that currently competitive
31 incumbents would oppose because it reduces efficiency? It
32 seems to me that there are -- the Rulebook process provides an
33 opportunity to impose costs on others, such as new entrants,
34 to the benefit of the incumbents which overall could be to the
35 detriment of competition.

36 It seems implausible, for example, that the incumbents
37 would enthusiastically vote for a rule change which
38 dramatically reduces barriers to entry.

39 **MS REBSTOCK:** We've asked the question about cases where pro-
40 competitive rule changes have been vetoed or looked -- in
41 terms of the Market Surveillance Committee -- about cases
42 where anti-competitive rule changes have had to be struck
43 down.

44 We haven't had an overwhelming amount of evidence of
45 this mischief which the Commission itself has identified as at
46 least theoretically possible. I suspect you are going to come
47 to that later.

48 **DR SUNDAKOV:** We'll come to those issues later. But I think
49 also, as I said before, the comparisons are very subtle and
50 it's not the sort of environment where you would find explicit

1 mischief. That's exactly the kind of thing that is easily
2 visible.

3 I think what's more likely is that there will be things
4 that are exceptionally difficult for outsiders to assess,
5 where very subtle industry interests will try to manipulate
6 the process to their benefit.

7 Also, it's probably more do with the fact with how many
8 pro-competitive rule changes we're likely to see versus the
9 deliberate attempt to go the other way.

10 **MS REBSTOCK:** The fact that they're hard to see as an outsider,
11 aren't we reliant then upon the dynamics within the industry
12 to identify at the margins what's going on in internal
13 tensions within the industry to police?

14 **DR SUNDAKOV:** To the extent that that will surface them, yes, but
15 that will not surface all of them, and that is precisely why I
16 come back to the question of, how will Government be involved?
17 If the Government is to have any chance at all of being able
18 to pick up on these things, it can't be involved in the sort
19 of -- in the form that's being proposed under the industry
20 EGB, where it kind of -- you know, it stands aside and
21 observes and sees problems and then comes in, because I think
22 it's unlikely to see those problems.

23 **MS REBSTOCK:** I mean that could be a powerful argument for an
24 industry EGB as well, in the sense that it takes industry
25 players to see what's happening. But I'm sure you are going
26 to come back with some further examples.

27 But I did want to ask you another question that relates
28 to a number of comments that you have made.

29 When we talk about new entrants, I think if we set up a
30 dichotomy where we have the incumbents and we have new
31 entrants, it suggests that the future of generation capability
32 will all be by new entrants. Where in fact, isn't it likely
33 that the current players will themselves build that new
34 capability and in fact they seem to be doing just that now.

35 So, I wonder if the analysis is really that clean
36 between barriers to entry where the old guard sits back with
37 their fixed investment and tries to block any new investment.

38 If we actually see that they are investing in new
39 generation capability, doesn't that do some damage to this
40 notion that somehow they're going to use their market power,
41 or that they are using market power to -- or they have the
42 incentive or the ability to block lower cost investment.

43 **DR SUNDAKOV:** I think you're absolutely right, I think the
44 analysis isn't clear. I think what we're talking about is the
45 differences at the margin, and I think that that's -- yes,
46 that there's no doubt that the incumbent operators will also
47 be looking at different technologies, and from time to time
48 they will be seeking rule changes that enable alternative
49 technologies that they themselves are interested in to come
50 in.

1 That is not to say though that they will also not have
2 an incentive to attempt to prevent, as far as possible -- and
3 again, this is not a sort of an accusation, if I was in issues
4 I would do exactly the same -- to attempt to prevent entrants
5 who may bring different technologies to what they themselves
6 would prefer.

7 **MS REBSTOCK:** You may have the incentive, but whether you have
8 the ability; and if we look out there and we see them actually
9 investing in new technology themselves, whether it's wind or
10 whatever, that suggests that they're not willing to run the
11 risk of getting caught out, and as soon as they invest doesn't
12 it open up the whole market to new entrants?

13 **DR SUNDAKOV:** I think it's partly to do with the scale of
14 investment. They may be picking up new technology, but not
15 necessarily going at a particularly small scale and I think
16 there's a big issue, particularly if we start talking about
17 distributed generation, about just what is a viable scale of
18 investment, and that comes into a whole series of interactions
19 with the Rules.

20 But I think also, you're right, I come back to my point
21 right at the beginning, that the comparisons between
22 regulatory regimes here are very subtle and the line that you
23 would draw between a Government EGB and an industry EGB with
24 significant Government involvement isn't absolutely clear-cut.

25 I think though the question is, where does the balance
26 of risks lie? It seems to me that the balance of risks still
27 lies in terms of the industry being able to use the industry
28 EGB as a club to promote its self-interest, simply because it
29 is very difficult for outsiders to pick all these different
30 elements that go into making the industry competitive. Even
31 though we think the industry is fairly competitive, we know
32 that it's also got elements of market power, and these
33 elements will have to be exercised.

34 **MS BATES:** Just getting back to what you are telling us about how
35 the industry EGB has more potential for the industry in subtle
36 ways to act in its own interests rather than the wider good,
37 or -- what I want to ask you about it is this: Transpower's
38 representative of course, it is an industry player, it would
39 pick up these subtleties no doubt. The Minister's there in a
40 monitoring capacity; wouldn't Transpower simply bring these
41 concerns to the attention of the Minister?

42 **DR SUNDAKOV:** It may. I'm not entirely sure -- this is an
43 uncomfortable thing to say sitting among Transpower staff --
44 but I'm not entirely sure it's going to be in Transpower's
45 interest to bring these things out, and Transpower is also a
46 player in the industry. It has a public good objective, it
47 also has a commercial objective.

48 **MS BATES:** The example you gave about investment and security are
49 ones that Transpower would take a different view?

50 **DR SUNDAKOV:** That's right.

1 **MS BATES:** Why would it be ineffective to informally lobby the
2 Minister on it?

3 **DR SUNDAKOV:** It probably will. You can easily imagine a
4 situation where the Minister will come back with a Government
5 Policy Statement dealing with a specific -- you know, you can
6 sort of imagine the process where, because the concerns that
7 may be captured by Transpower or concerns that may be captured
8 by other industry players lobbying the Minister, the Minister
9 ends up with coming out with numerous Government policy
10 statements covering a wide range of operations of the industry
11 EGB.

12 But what I'm saying is that if you get to that stage,
13 how do you describe that as an industry EGB? Where do you
14 draw the line? When Mr Caygill spoke, he emphasised that what
15 makes the industry EGB efficient, what makes the industry EGB
16 is the fact that the decisions at the end of the day belong
17 with the industry voting process.

18 Now, either that's true or that's not true; it's not
19 true because the Government will keep pushing and influencing
20 those voting outcomes.

21 **MS BATES:** Which is a possible scenario.

22 **DR SUNDAKOV:** Which is a very possible scenario, but in that case
23 we're no longer talking about an industry EGB. We're talking
24 about something like the Crown EGB, but a sort of Crown EGB
25 through the back door, and what you have to ask is, is this an
26 efficient way of introducing a Crown EGB rather than doing it
27 explicitly through the accountability processes and all the
28 sort of normal ways that we have of organising these things.

29 **MS REBSTOCK:** Thanks.

30 **DR SUNDAKOV:** Let me move on, and again I think your questions
31 pre-empted some of the things I wanted to say, but let me move
32 on to the question of decision quality.

33 I think that again it's important to be very careful in
34 comparing the proposal and the counterfactual here. There are
35 a number of points that the applicants make here with respect
36 to decision quality and the number of points that get picked
37 up in the Commission's Draft Determination.

38 In particular the Commission, as you know, comes out in
39 picking whether there is some benefit from improved decision-
40 making that comes out of better information that is available
41 to industry decision-makers.

42 I think it's very important to put this into the broader
43 context. Decision quality depends on information that's
44 available to decision-makers, it also depends and the
45 incentives and how the opposing views get reconciled.

46 It seems to me that, if self-interest dictates that bad
47 decisions are made, decisions that are perhaps self-interested
48 and weren't necessarily in the broad efficiency interest, no
49 matter how good your information is, you are still going to
50 come out with bad decisions. So I think it's important not to

1 confuse the quality of information here with the broader
2 structure of decisions and particularly the incentives that
3 drive them.

4 **MS BATES:** Whilst you can accept that good information doesn't
5 necessarily mean good decisions; lack of information can lead
6 to bad decisions by good decision-makers.

7 **DR SUNDAKOV:** That's absolutely right. If I can come to that; I
8 think the point has been made a number of times that the
9 industry EGB would make better decisions because industry
10 working group participants have better information than people
11 outside the industry. I think there has been some debate
12 about, why doesn't the Government use working group processes
13 as well?

14 The point I'd like to emphasise, the point that I think
15 is absolutely key to me, when you are talking about
16 information and who has better information, the key question
17 is, does that information have to be transmitted to third
18 parties who are not themselves industry specialists?

19 If it doesn't, if you can sort of rely on osmosis that
20 people with particular engineering backgrounds grunt to each
21 other and understand what's going on, then I think you can say
22 having industry participants produces a much better decision
23 simply because it consists of members of the industry. But as
24 soon as information has to be transmitted to non-specialists,
25 as soon as it has to be explained to third parties, whether
26 the third parties happen to be the industry EGB members who
27 can't be industry insiders, or the third parties happen to be
28 Government officials who are hovering around monitoring the
29 process, or the Minister, these benefits of osmosis get lost.

30 It seems to me that when you're comparing the industry
31 EGB and the Crown EGB in fact the information requirements are
32 very very similar. Very difficult to see the difference. You
33 still have to explain complex technical information to third
34 parties. You still have to verbalise a lot of complex
35 concepts for people who are not specialists and not engineers.

36 In that sense -- and you still have the same opportunity
37 to use specialist knowledge as you would under an industry
38 EGB. So my feeling is, I actually can't see any difference
39 between the two.

40 **MS BATES:** I just want to clarify so that I understand what you
41 saying about the non-specialists. You see those non-
42 specialists as being the EGB board members.

43 **DR SUNDAKOV:** Well, the EGB board members cannot be industry
44 insiders. So the industry EGB are not as highly specialised
45 as the industry working groups.

46 **MS BATES:** They could be theoretically because they wouldn't have
47 information specific to particular companies, which could be
48 important, but you theoretically could have people with a
49 higher degree of expertise on either an industry EGB or a
50 Crown EGB.

1 **DR SUNDAKOV:** That's also true. Or you could have people without
2 expertise. You are also going to have Government officials
3 who would need to understand, and you are also going to have
4 the Commerce Commission.

5 If you're talking about a process where the backstop is
6 having to come back for authorisation, there's going to be a
7 lot of non-grunting that's going to be involved in explaining
8 all these issues to you folk.

9 **MS BATES:** When the industry's voting it may not have dialogue
10 about how it's going to vote, amongst itself, but when the
11 industry EGB is formulating policy -- as I anticipate it
12 would -- then it would be having that information that's
13 necessary delivered to it.

14 **DR SUNDAKOV:** Exactly. The same way as the Crown would. What
15 I'm saying is that in terms of information availability and
16 the transmission of information, I don't perceive any
17 difference between the Crown EGB and the industry EGB.
18 Particularly if you put the industry EGB into these broader
19 Government and regulatory environments that it's suggested it
20 should be seen in that it's not a bunch of industry people
21 understanding each other without having to communicate complex
22 information.

23 I think also there's a question of independence of
24 decision-makers and Mr Thomson raised the question of, what
25 would be the motivation of industry EGB board members. It
26 seems to me that -- again, you can't have it both ways, either
27 the industry EGB is an independent decision-maker, in which
28 case one wouldn't expect it to be readily overridden by the
29 industry vote. Or if the proposal is that as soon as anything
30 is controversial and independence is really required you
31 immediately go an industry vote, then it seems to me very
32 difficult to claim any sort of value of independence from the
33 industry EGB.

34 The final point, the point I've already made is that the
35 consumer voice is likely to be relatively ineffective in this
36 whole process under the industry EGB and probably has a
37 slightly better chance -- although consumers never get much of
38 a hearing -- but it has probably a slightly better chance than
39 the Crown EGB Governmental environment.

40 **MS BATES:** That's not what the major users said to us, that they
41 would prefer a Crown -- they'd prefer an industry EGB but not
42 this industry EGB.

43 **DR SUNDAKOV:** Right.

44 **MS BATES:** They don't express a preference for a Crown EGB, and
45 one assumes they might have some quite sensible views on what
46 is in their own interest.

47 **DR SUNDAKOV:** That's probably true. It also is a question of
48 what kind of industry EGB and whether the industry EGB they
49 prefer is effectively what we would call a Crown EGB.

1 **CHAIR:** You may cover this later on, Professor Hogan made much of
2 the fact that, if there were a specific regulator, and I think
3 he was defining it along the lines of a mixture of FERC and
4 possibly state regulators, then there would be in essence
5 direct control over I think major events was his concern.

6 Do you see a Crown EGB in essence intervening heavily in
7 the electricity market and in essence becoming a dedicated
8 economic regulator, rather than a decision-making body as is
9 proposed here?

10 **DR SUNDAKOV:** I think it's relatively unlikely. I think it comes
11 back to the Government's stated preference for what the
12 Government called self-regulation. I think there's a very
13 good reason why the Government's stated that preference and
14 that's that clearly Ministers in New Zealand have had enough
15 experience of being held accountable for jumping into things
16 and regulating industries very closely.

17 So, I interpret the Government's preference for industry
18 self-regulation is just simply saying that we see ourselves
19 playing a relatively limited role in this industry. I think
20 that would be translated directly into the way the Crown EGB
21 would operate. The Minister clearly will not be interested,
22 given that underlying preference in self-regulation, will not
23 be interested in turning the Crown EGB into a heavy industry
24 regulator.

25 **CHAIR:** Because that was the way I interpreted Professor Hogan's
26 end piece after he presented his paper and then in the
27 discussion subsequently. He seemed to be saying that direct
28 and prescriptive intervention was really the only answer, but
29 maybe I mis-read him.

30 **DR SUNDAKOV:** I think the way -- and I'm not trying to interpret
31 Professor Hogan -- but the way I interpret what he was saying,
32 the way I tend to think about it is that there's a role in
33 this industry for an agency that can step outside the complex
34 web of interests that exists within the industry. Whether it
35 is the Government that plays a very heavy role in the industry
36 EGB or whether it's a Crown EGB where the Government plays a
37 role, you know, one may describe these matters of degree.

38 My preference, I think, is for an explicit Crown EGB
39 because I think that Government regulation by telephone calls
40 and by subtle pressure is really the worst possible kind of
41 regulation, because it's very very difficult to hold
42 Government accountable for it. If the Government is going to
43 play a role it should play a role within the context of well-
44 established accountability institutions.

45 **CHAIR:** Again, I'm just postulating; an active Minister together
46 with the Crown EGB members appointed by that Minister subject
47 to that Minister's determination as to the length of tenure;
48 do you see a similar situation as you suggest for the other
49 model arising?

1 **DR SUNDAKOV:** I'm sorry, I'm not sure if I understand the
2 question.

3 **CHAIR:** You are appointed by the Minister and you can be
4 dismissed by the Minister. So, is that intrinsically
5 different as you say the industry EGB may have -- I think you
6 mentioned whispers or winks or something -- whispers and phone
7 calls you talk about.

8 If you are appointed by the Minister to the Crown EGB
9 and you were there at his or her pleasure, would it be any
10 different?

11 **DR SUNDAKOV:** I think where it would be specifically different is
12 that the Crown EGB makes recommendations to the Minister, and
13 the Minister at the end of the day is accountable for making
14 the decisions. In other words, if a regulation is recommended
15 by the Crown EGB and the Minister acts on that regulation, and
16 that regulation is strongly opposed by all the members of the
17 industry and by consumer representatives, it's going to be
18 exceptionally difficult for the Minister to justify that.

19 So I think that the Minister's incentives are, where
20 you're explicitly accountable, the Minister's incentives are
21 going to be to take much more care than if you are not
22 explicitly accountable, you know there's an industry board,
23 and if you push them in one direction and it doesn't quite
24 work, well, it's actually the industry board's responsibility.

25 I think there's no doubt that the Minister can exercise
26 a lot of influence over the recommendations that have come out
27 of the Crown EGB, but by being explicitly accountable for the
28 decisions, I think the Minister's incentives shift. It is
29 very likely to make the Minister much more cautious and much
30 much more conscious of the consequences of the recommendations
31 and the decisions rather than the sort of pressure that
32 Ministers can exercise behind the scenes where the costs are
33 much more widely spread, the political costs, if you like.

34 **MS REBSTOCK:** The whole direction of public sector reform in New
35 Zealand and other countries has been to remove Government
36 Ministers from direct decision-making on industry matters.
37 This flies right in the face of that in terms of the
38 counterfactual.

39 **DR SUNDAKOV:** I think you are right, I think it does, and that's
40 something that worried me a lot. And the way I have come to
41 think about it, and in a sense what makes it so difficult to
42 decide exactly what the counterfactual is; here is a process
43 where quite a lot of thought and attention had gone into
44 deciding what the industry process would look like. Whereas
45 the Government has explicitly announced that there is this
46 fall-back position of a Crown EGB, but there hasn't really
47 been a significant investment into how this will operate.

48 **MS REBSTOCK:** Actually, it's been legislated for. It's a bit
49 stronger than announced.

1 **DR SUNDAKOV:** There's a lot of people in this room that have been
2 involved in various institutional designs and, you know, how
3 much detail is involved in figuring out how the institutions
4 work. I think it's quite obvious that the same hasn't been
5 done here in relation to a Crown EGB and that's partly because
6 it is a fall-back position.

7 **MS REBSTOCK:** If we just focus on this Ministerial decision-
8 making, are you aware of any country that gives the Minister
9 final decision-making authority on the Rules of the
10 electricity system?

11 **DR SUNDAKOV:** Not in the same explicit way that's currently in
12 the Crown EGB, but I think that there are certainly numerous
13 countries where there are politically appointed regulators
14 which have one form or another of accountability to the
15 Minister.

16 But can I just finish my thought though, and I think if
17 the Crown EGB became a reality, what you would find is there
18 would be a lot more investment in making it work well, and it
19 may well evolve away from this current arrangement.

20 **MS REBSTOCK:** Sure. Can I ask you though; we had an interesting
21 comment from Dr Turner from Meridian that this Crown EGB is
22 not -- I don't know the exact words he used -- but the "usual"
23 regulated option, and in that it had the Minister making the
24 final decisions and normally you have an independent board
25 making those decisions, even if they are appointed by the
26 Crown.

27 Now, he put a lot of weight on that; so much weight that
28 it led him to prefer one model over the other. You seem to be
29 almost suggesting that there's little difference. Is that
30 unfair to say that?

31 **DR SUNDAKOV:** I think that I see relatively little difference
32 between the Crown EGB as is currently described in the
33 legislation and the proposed industry EGB with significant
34 Government involvement, where the Minister plays -- inevitably
35 would have to play a very detailed role.

36 What I do see I think as being a potential point of
37 difference over time, as I was just saying before, I don't
38 think that, if the Crown EGB became a reality, it would
39 necessarily remain in exactly the same form as it is currently
40 very broadly described. I think one of the things that the
41 Minister who has expressed preference for self-regulation
42 would probably do very rapidly is to try to separate him or
43 herself from a Crown EGB so it will be given much more
44 independence.

45 **MS REBSTOCK:** I would have thought that the Commission, in terms
46 of the counterfactual, there couldn't be a much stronger
47 indication of what the Government intends to do other than
48 what it has actually passed into legislation.

49 So, I understand you are making the point that you think
50 it would evolve from that, but the Government was serious

1 enough about the preferred alternative that they put it into
2 legislation.

3 So, I'm not sure really what sort of weight we could
4 give to this notion that surely this would have to evolve away
5 from the Minister making the decisions.

6 **DR SUNDAKOV:** I don't think you need to give any weight to that
7 and that's because I don't think it actually makes that much
8 difference. I think in evaluating the proposal in the
9 counterfactual, you don't need to assume this. I think the
10 question that you have to ask is, what would be the incentives
11 on the Minister acting on the recommendations of the EGB
12 versus the incentives on the industry EGB and evolving into an
13 industry vote, are the things you need to weigh up, and that's
14 really all I tried to weigh up in my remarks.

15 I think the key point about the Government's role in all
16 of this is that we're clearly not saying, here is a model the
17 Government plays no role in, here's a model that the
18 Government plays the absolute role of some sort of mad central
19 regulator or central planner. In fact the two do merge and in
20 the middle it's relatively difficult to find any difference
21 between the two.

22 But I think where the difference does exist, it's a
23 difference between an explicit Government role which can be
24 captured through accountability arrangements and implicit
25 Government role which Governments working behind the scenes
26 are always a lot more difficult to hold accountable, they are
27 always a lot more prone to weighing short-term political
28 interests over long-term interests.

29 **MS BATES:** Well, wouldn't you say that the Minister having a
30 final decision-making power with the Crown EGB, that there is
31 the potential for the Minister to make decisions which are not
32 necessarily looking at the long-term because of susceptibility
33 to political pressure.

34 **DR SUNDAKOV:** Absolutely.

35 **MS BATES:** So, the Minister is not sufficiently distanced from
36 the decision-making --

37 **DR SUNDAKOV:** That's absolutely right. But the Minister equally
38 has the same susceptibility under the industry EGB for the
39 same political pressure -- if the pressure was to resolve a
40 pricing problem in winter, the Minister, driven by short-term
41 political pressures, may equally exercise those options under
42 the industry EGB but do it much more implicitly and behind the
43 scenes and in a sense have a free hand in making those short-
44 term decisions rather than if that Minister is more explicitly
45 accountable. Under both regimes certainly Ministers can do
46 silly things.

47 **CHAIR:** That seems dynamic, because occasionally this body makes
48 decisions that Ministers are only too pleased to say it was
49 the Commission, not them; anyway.

1 **DR SUNDAKOV:** That's precisely my point, that's precisely why
 2 industry EGB -- the Government pushing the industry in a
 3 particular direction from behind the scenes is often going to
 4 be a preferred way of achieving short-term objectives than
 5 doing it explicitly.

6 **CHAIR:** I should make it clear that the Government doesn't put
 7 this organisation from behind the scenes.

8 I think philosophically to be able to say it's somebody
 9 else doing it has some attraction in certain circumstances.

10 **DR SUNDAKOV:** If I may just very quickly sum up. I think one
 11 cannot emphasise too much just how complex the choice is here
 12 and how many factors -- the choice between two regulatory
 13 regimes is multi-dimensional and there will be some dimensions
 14 where one regime works slightly better than the other.

15 But I think overall it seems to me that the balance of
 16 risks lies here against the proposal, the balance of risks
 17 here is that the self-regulation is likely to work less well,
 18 less efficiently than Government regulation in this particular
 19 case.

20 I think in this context one has to be very cautious
 21 about the idea that, why not just wait and see why not go down
 22 the path that's been suggested that the Government says that
 23 if the industry self-regulation doesn't work it always has
 24 this option of coming back with a Crown EGB, so why not let
 25 things roll out and see whether it works or not.

26 I think the problem is that the failures here are not
 27 obvious, to the extent that the industry EGB may result in
 28 some costs being passed on to consumers or to new entrants.
 29 These will not be easily picked up, and problems can exist for
 30 a long time until something goes spectacularly wrong, the way
 31 it happened in California. The problem is, when it goes
 32 spectacularly wrong, if the Government steps in at that stage,
 33 it's going to step in and overreact. When Governments respond
 34 to crises of this kind, it's unlikely to come in with a mild
 35 version of an industry EGB but it's much more likely to
 36 overreact. So, there's a significant risk to letting things
 37 roll out and waiting for problems to emerge.

38 **CHAIR:** Okay, just thinking on that, we might give the
 39 transcriber a chance to draw breath. So, thanks very much
 40 for, A your presentation, and B the dialogue because it's very
 41 important. So we'll break until just after 12.

42 **Adjournment taken from 11.55 am to 12.05 pm**

43 **CHAIR:** We'll resume, please.

44 **MS CALLINAN:** If I could continue. The first topic that we had
 45 listed to speak to was decision-making, and I'm conscious of
 46 the fact that we've already got some way into that discussion
 47 with the Commission, so I'm not going to stick to the script.

48 **CHAIR:** I just make the point, please take as long as you have
 49 to. It's very important that every party has the opportunity
 50 to say what they want to say. I've said to everybody else the

1 same thing; we can make the time if there isn't enough time,
2 that's all.

3 **MS CALLINAN:** Thank you for that.

4 I think the issue is clear, about the relevance of
5 decision-making, and just to pick up on where the Commission
6 left off with Alex; the main point that Transpower is making
7 in this submission is that there isn't -- even if the
8 Commission doesn't accept Transpower's view that there will be
9 better quality decision-making under a Crown EGB -- at the
10 very least what we're trying to argue is that the gap between
11 decision-making under an industry EGB and under a Crown EGB is
12 not as big as was reflected in the Draft Determination, and
13 that really is the simple point that we're trying to get
14 across.

15 At paragraph 1.4 of our submission I just -- and this is
16 typical to the submission -- I'll just summarise where
17 Transpower's intending to go and then we'll come back to those
18 points.

19 The first point in A is that contrary to the applicant's
20 evidence Alex has already explained why in our view self-
21 interested decision-making in this industry will not maximise
22 public benefits. We've been speaking at a theoretical level
23 about that and in a moment I'll turn to Nicki Crauford who
24 will give you a practical example that might help to put that
25 in perspective.

26 The second point we want to come to in this section is
27 looking back and looking at the counterfactual and taking what
28 we consider to be a realistic look at what the Crown EGB will
29 look like and I think there was a lot of that coming through
30 in the dialogue that you've just had with Alex.

31 The third point is a little bit more specific about how
32 we see the information flows will be working in a Crown EGB
33 scenario, and why we consider, on balance, largely because of
34 the incentives of the different parties, that there will be
35 better quality decision-making coming out of the Crown EGB.

36 On paragraph 1.5, from time to time in the submission
37 you will see that we have referred to Professor Hogan's
38 evidence; we don't propose to reiterate what he said, but we
39 have provided cross-references to his transcript where we
40 think that might assist the Commission in reviewing the
41 submissions.

42 So, what I would like to do really is just turn over to
43 Nicki Crauford who will pick up on where Alex has left off in
44 the theory and give a practical example of self-interested
45 decision-making in the industry using the example of losses of
46 constraint rentals.

47 **DR CRAUFORD:** I'd like to give the example of allocation of loss
48 rentals and for this I will be using both the -- what is on
49 page 7 of our notes, but also one of the appendices, page 21
50 of the of the appendices, which is a summary of the decisions

1 or what has happened in various working groups and industry
2 involvement in the allocation of loss and constraint
3 surpluses.

4 **MR CURTIN:** Just before you get underway would you care to recap
5 for us all how the rentals arise?

6 **DR CRAUFORD:** Yes. I was going to do that. I should first of
7 all explain what loss and constraint rentals are; I'll try and
8 do that simply without going into huge detail as to how nodal
9 pricing works.

10 The concept behind it is that, nodal pricing is in
11 effect a way of managing transmission constraints. The energy
12 price on the system, if there were no transmission losses and
13 no constraints, the energy price would be the same at all 244
14 nodes on the system for any particular half hour. It will
15 vary from half hour to half hour according to generator bids
16 and offers, but it will not vary because of transmission
17 constraints and losses.

18 The variation around the system is due entirely to
19 losses and constraints, and the rentals derive from the
20 difference between the price at any two different nodes. The
21 constraint rentals, for example, are -- it is the exact
22 difference between the price, between two different nodes and,
23 therefore, forms a natural hedge if you want to hedge
24 yourselves against the impact of constraints.

25 Does that explain it at a reasonable level?

26 **MR CURTIN:** [nods].

27 **DR CRAUFORD:** The value of loss and constraints is an important
28 issue. Roughly \$60 to \$100 million per annum and their value
29 has exceeded, I think, \$500 million since the beginning of the
30 wholesale market in 1996, so we're talking about a significant
31 amount of money.

32 The decision was made in 1996 that the rentals that
33 should be allocated to Transpower, who should then use them
34 either to fund a hedge product against the impact of losses
35 and constraints, or they should be allocated in a way that
36 does not destroy the nodal pricing new investment signals.
37 This was agreed in 1996 and it was immediately contentious.
38 The introduction of a transmission hedge has been discussed in
39 the industry since 1990. It wasn't introduced in 1996, I
40 think quite simply because of lack of time. Transpower
41 introduced another simpler product at the time which was then
42 withdrawn in 1998 because of lack of interest.

43 However, there has been consistent independent economic
44 support for Transpower's position, which is that the loss of
45 constraint rentals derive from transmission and should be
46 allocated to the grid owner, who should then pass them on in a
47 way that does not destroy the nodal pricing signals.

48 As I say, this was contentious from the beginning and
49 over the years a number of working groups have been set up
50 under NZEM to look at the allocation methodology, and a large

1 number of allocation methodologies have been suggested by
 2 various parties. Each of them are suggesting that money
 3 should be returned to themselves.

4 So, for examples, the generators/retailers have
 5 suggested that the loss in constraint rentals should be
 6 returned to them. The lines companies are happier with the
 7 allocation that Transpower currently uses.

8 These working groups, none of them have actually been
 9 able to reach a consensus amongst themselves on this issue.
 10 So, Transpower obviously has been involved in those working
 11 groups as well, and we have also had an opinion that economic
 12 efficiency and that the preservation of the new investment
 13 signals through nodal pricing is the most important issue
 14 here.

15 **MS REBSTOCK:** How does Transpower allocate it now?

16 **DR CRAUFORD:** We allocate out the loss in constraint rentals to
 17 the party who pay for the sunk costs who are largely the lines
 18 companies and direct connect companies with some of it also
 19 going to the generators if they pay for sunk costs.

20 **MR THOMSON:** We allocate the whole lot. We do not keep any of
 21 it; we pass it all through.

22 **MS REBSTOCK:** On this opinion, there's more than one opinion
 23 floating around on this issue, isn't there, on what is
 24 economically preferable?

25 **DR CRAUFORD:** What is economically preferable in terms of how
 26 they should be allocated. Yes, there are a number. I think,
 27 though, that there has been a fairly consistent opinion that
 28 the rentals are derived from transmission and should be
 29 returned certainly in the first instance to the grid owner.

30 The difference of opinion has to do with what you then
 31 do with them; the development of a hedge product is one
 32 option. Allocating them to retailers instead of the end
 33 consumer is one, allocating to lines businesses is another.

34 The issue is much more around allocating them in a way
 35 that is both transparent, but does not destroy the nodal
 36 pricing signals and that who they should be returned to in
 37 Transpower's opinion.

38 As I say, there has been no consensus and indeed a
 39 number of the allocation methodologies proposed within the
 40 NZEM has also been opposed by non-NZEM members as well. It is
 41 our view that this situation would not be improved under the
 42 new Rulebook, that the Rulebook simply entrenches the control
 43 of generators and retailers over the allocation of loss and
 44 constraint rentals, and the Rules do provide for Transpower to
 45 collect the rentals, but under Part H of the Rulebook the
 46 generators and retailers get all the votes as to how they
 47 should be allocated, and this is an issue that affects much
 48 more than simply the generators retailers, it affects the
 49 whole of the industry.

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1 **MS REBSTOCK:** When you say "they get all of the votes", do you
2 mean they literally have all of the votes, or are you
3 suggesting they have enough votes to carry their position?
4 **DR CRAUFORD:** They literally have all of the votes under Part H
5 of the Rulebook.
6 **CHAIR:** All right. Thank you.
7 **MS CALLINAN:** Are there questions on this?
8 **MR CURTIN:** We'll be coming to FTRs more generally later?
9 **DR CRAUFORD:** Yes.
10 **MS CALLINAN:** The simple point that we were using this example
11 for is that -- I mean, there's a theoretical view that the
12 participants will act in their self-interest, and it seemed to
13 us that this was a good example where there was -- and please
14 correct me if this is not a fair summary -- but that there was
15 a consensus in the industry that financial transmission rights
16 were needed, that a logical way to fund those financial
17 transmission rights is through the loss in constraint rentals
18 and that that would be in everyone's interest to have
19 financial transmission rights. Yet there was some movement
20 within the industry about whether those rentals should
21 actually go to Transpower or should be re-allocated, and that
22 seemed to be contradictory.
23 **MS REBSTOCK:** I'm just trying to get a handle on the voting under
24 Part H. Is it right that it's allocated among generators,
25 purchasers and other buyers and sellers of ancillary services?
26 Who do we mean here by purchasers and buyers? I'm just asking
27 you just because I realise I didn't understand this. Who
28 essentially has building rights?
29 **MR CARVELL:** As I understand it purchasers are retailers and
30 direct connect customers. People who are purchasing
31 electricity in the wholesale market.
32 **MR THOMSON:** So, who gets the votes under the Rules, the total
33 vote? You've only answered one bit, Alan.
34 **MR CARVELL:** It's generators on one side and purchasers,
35 retailers and direct connect customers on the other.
36 **MS REBSTOCK:** And the lines companies don't come in to play a
37 role?
38 **MR CARVELL:** No.
39 **MS REBSTOCK:** So when we refer to buyers and sellers of ancillary
40 services, who are we referring to there? I know this is not
41 your paper, I'm just trying to make sure I understand this.
42 **MR HEAPS:** The purchasers of ancillary services can be the
43 generators and the line companies, and the providers of
44 ancillary services can be generators, lines companies and
45 others.
46 **MR THOMSON:** But the majority are the purchasing of ancillary
47 services with generators, the lines companies don't purchase
48 that much, they're only on the voltage.
49 **MS REBSTOCK:** But if they are on the voltage then do they have
50 voting rights here?

- 1 **MR THOMSON:** They don't purchase.
- 2 **MS CALLINAN:** If Brett Piper, general counsel, can answer this
3 point for us.
- 4 **MR PIPER:** I think the allocation isn't crystal clear, but our
5 understanding was originally the votes for Part H were simply
6 divided on the basis of sales and purchasers of electricity
7 through the electricity market; in other words, the current
8 parties to the NZEM. Subsequently it was realised that the
9 Rules under Part H also dealt with purchase and settlement of
10 ancillary services which are largely going to be purchased
11 from generators and largely paid for by generators.
- 12 **MS REBSTOCK:** When you say "largely", does the vote go in
13 proportion to the extent of your --
- 14 **MR PIPER:** It's based on the amount of transactions across the
15 market. So, while there will be some value in ancillary
16 services transactions, perhaps 20 million? Correct me if I'm
17 wrong. That pales in comparison to the overall amounts
18 transacted across the wholesale energy market. So, I wouldn't
19 like to hazard a guess at percentages, but the vast majority
20 of votes under Part H will be held by buyers and sellers on
21 the energy market.
- 22 **MS REBSTOCK:** And my question, and I think you've said it, that
23 you get your votes in proportion to whatever you're expending
24 or purchasing, is that --
- 25 **MR PIPER:** The particular entitlement is set out in part A
26 governance schedule A6 where it talks about allocative amongst
27 general retailers, purchasers, other buyers and sellers on the
28 basis of value of services.
- 29 **MS REBSTOCK:** Yeah, that's what I was looking at.
- 30 **DR CRAUFORD:** Under that Transpower would not have a vote under
31 that, even though loss in constraint rentals, we would think,
32 would have some impact on us; there would be no votes to
33 Transpower under that. Is that right? Transpower has no vote
34 under that part?
- 35 **MR PIPER:** It might have a minuscule vote to the extent that it
36 might be a purchaser of ancillary services, but I imagine
37 we're talking 1 or 2 percentages. I mean, again I'm guessing
38 at the percentages, but I would guess that
39 retailers/generators would have over 90%, 95% plus of the
40 votes.
- 41 **MR CURTIN:** Coming back to your characterisation of this episode
42 as illustrating the self-interest to the industry. I think we
43 had it from somebody last week -- I'm sorry but I can't
44 remember whom -- who is saying that they were perfectly happy
45 with FTRs. What they didn't much like was Transpower's design
46 of the FTR regime. I think they also said that they had a
47 gripe, and maybe perhaps more than what the person said, was
48 that they had a gripe over the consultation with your proposed
49 design for FTRs.

1 I suppose in that context could it be said that there's
 2 a bit of a bun fight going on and people are grabbing bits of
 3 leverage where they can, and that's an alternative explanation
 4 of the grabbing of the rentals in the midst of this
 5 negotiation?

6 **DR CRAUFORD:** I think your summation is about right. I think
 7 that the debate has been occurring since 1996, this has been a
 8 contentious issue since then. There has not been consensus on
 9 what to do with the rentals since that time, and this isn't
 10 simply an issue of Transpower against the rest of the
 11 industry; there is not consensus even amongst NZEM members as
 12 to what to do with the rentals, and yes, I would suggest that
 13 to a large degree that is because a significant amount of
 14 money is involved.

15 In relation to the issues on FTRs, I was going to cover
 16 that later, but I can certainly go through some of that now,
 17 if you'd prefer me to do so?

18 **MR CURTIN:** It's probably easier in its place, I would think.

19 **DR CRAUFORD:** There have been a number of working groups,
 20 something like four working groups, and none of them have
 21 actually managed to come to a decision on this issue.

22 It is a complex issue admittedly, but there are also a
 23 wide range of self-interests which I think is reflected in the
 24 fact that no consensus can be obtained.

25 **MR CURTIN:** It's not totally all square with perhaps Sundakov's
 26 comment about a club united in its pursuit of common interest?

27 **DR CRAUFORD:** Well, they're not united in pursuit of their common
 28 interest. Certainly I think that the generators and retailers
 29 have one view; the lines companies would have another.
 30 Certainly under NZEM, before the line energy splits, lines
 31 companies views were represented within the NZEM. Since then
 32 there has been less of a representation of consumers and lines
 33 interests, but I have to say that on this particular issue the
 34 most recent working groups, there has been acknowledgment that
 35 this is an issue that impacts direct on consumers and on lines
 36 companies and that they have been invited into those working
 37 groups, and their views have been represented. That's just
 38 probably the other factor which has led to a lack of
 39 consensus.

40 **MS CALLINAN:** If I could just continue, thank you Nicki.

41 We'd like now to just, if you like, set the scene for
 42 the discussion on decision-making, and of course many of the
 43 other issues that will follow, by just coming back to the
 44 counterfactual and what we see as a realistic scenario in
 45 terms of how the Crown EGB will look.

46 **CHAIR:** I just wonder whether -- I see we have a break at 12.30 -
 47 - whether we should take it now and perhaps come back at 25
 48 past 1 sharp so that we don't lose any time. So, with your
 49 agreement, we'll break now and start at 1.25 and then we can
 50 get on to 1.6. Thank you.

Adjournment from 12.26 pm to 1.25 pm

1
2
3 **CHAIR:** We'll start again, 25 past has arrived. Miss Callinan
4 please.

5 **MS CALLINAN:** Thank you, Mr Chair. Just before we get back on to
6 the written structure of the submission, we thought it might
7 be useful to return to one of the points that the Commission
8 raised prior to the lunch break. In the discussion with
9 Mr Sundakov one of the issues that came out was whether there
10 would be self-interested decision-making.

11 As we understand the distinction that Commissioner
12 Rebstock was trying to draw, that there's market power in the
13 market for generators and retailers, and whilst they might
14 have incentives to exercise that market power, the question is
15 whether they would also have the opportunity to do so given
16 that there is a reasonable level of competition in both the
17 generation and retail market.

18 We thought that that was a point worth returning to
19 before we moved on to our submission and we want to say that,
20 in relation to the generation market there is, in our
21 submission, both the incentive and the opportunity under the
22 industry EGB model to take advantage of market power, and
23 we'll just return in that regard to the example that Nicki
24 Crauford gave before lunch because at the end of that
25 discussion we focused on the voting rights under Part H, and
26 it was clear that that was largely controlled by the
27 generator/retailers; so, we just offer that as an example of
28 where there is both incentive and opportunity.

29 As to the question of whether there is competition, what
30 level of competition there is in the retail market, I will ask
31 Mr Heaps to perhaps just comment on that and assist the
32 Commission with that issue.

33 **MR HEAPS:** Whilst Transpower doesn't have direct information on
34 the retail competition, these are really based on observation.
35 However, we do see that verticle integration is occurring in
36 the retail and generation market, and that is occurring more
37 rapidly. In some respects that is a response to generators
38 managing the risks of locational prices in the absence of a
39 hedge product such as a financial transmission right.
40 However, that does appear to be occurring. We're seeing
41 issues where customers have been exchanged between retailers
42 without those customers having a say in that. And again, that
43 appears to be to move retail bases to the location where the
44 generation occurs.

45 Another observation is, and I think we could all make
46 it, is a personal one; that we used to see active competition
47 for our business. I think in the first two years of the
48 market I moved -- personally moved retailer four times. I
49 haven't done that for the past 14 months and nobody's knocking
50 on my door any more, so it doesn't occur, the television

1 adverts and those sort of things, the offers really aren't out
2 there in the market. I think that's a manifestation that
3 there isn't really as strong a competition as there used to
4 be.

5 Probably a more concrete example is where one of our
6 subsidiaries Decipher introduced a product into the market
7 which was based on reverse auctioning. So, large customers or
8 groups of customers could, on-line, put their electricity
9 purchases up for auction and generators could bid for that in
10 competition. It was unfortunate that this came -- we launched
11 that product in Decipher at the time of last winter. However,
12 the first auctions were Te Papa put their load up; zero, they
13 actually got zero interest from the generators. That product
14 isn't now available; Decipher had to withdraw it, it just
15 wasn't successful because there were no supply side offers,
16 even though we auctioned quite a few demands on demand side
17 bids there.

18 Now those auctions have been successful in the United
19 States. They have also been successful in Australia, but they
20 aren't successful here because there doesn't appear to be
21 sufficient interest from sellers to come to the party.

22 **CHAIR:** Thank you.

23 **MS CALLINAN:** Thank you. I'll just move on to the issue that we
24 started to talk about before lunch, which is the
25 counterfactual. As I said, Transpower's focus is on having a
26 realistic view of a Crown EGB. Transpower obviously agrees
27 with the Commissioner's identification of a Crown EGB as a
28 likely counterfactual, and in our submission the way in which
29 the applicant has characterised the counterfactual is not
30 particularly balanced. The phrase has been used once, if not
31 twice in the submissions, that the Crown EGB will be a central
32 planner.

33 This, to us has the connotation that there would be a
34 lack of recognition of market stakeholders. Just, the way the
35 legislation is structured, that's very unlikely because the
36 Minister has to consult with parties who are going to be
37 substantially affected before recommending regulation needed
38 to be passed by the Governor-General, and in any event
39 stakeholders are very likely, in our submission, to be
40 involved in the working groups.

41 Just moving on to point C in the submission: The
42 applicant has acknowledged the Minister has a role to play in
43 both scenarios but in the applicant's version the Minister is
44 a valuable influence which will guide the industry, in a way,
45 where it needs to go. But by contrast in the Crown EGB the
46 Minister could make arbitrary decisions, possibly ill-
47 informed.

48 The fact that the Minister has a greater degree of
49 influence in the Crown EGB does not justify the suggestion
50 that he or she will have radically different abilities and

1 incentives under each scenario. I think the discussion you
2 had with Mr Sundakov before lunch just reinforced our point
3 that the way in which a Crown EGB and an industry EGB are
4 likely to operate are not going to be that different, other
5 than the incentives point that we emphasised.

6 Transpower considers that a realistic assessment needs
7 to be made of the Crown EGB and looking beyond the guidance
8 that we already have from the Act and the GPS, and we'd
9 suggest that a Crown EGB would look a little bit like this.
10 It's likely to use working groups, although not necessarily
11 bound by what they say, and the PJM and NECA models are
12 examples of regulated bodies in other jurisdictions which use
13 the working group model.

14 So, we're saying that should be an assumption that is
15 relevant to both the arrangement and the counterfactual. The
16 Crown EGB may well adopt voting processes like the voting
17 processes in Part F. It's likely to be a full-time specialist
18 body, to that extent like NECA, and this would differentiate
19 it from bodies which currently deal with electricity only as
20 part of a wider portfolio.

21 It's likely that it would have a minority of industry
22 representatives sitting on the Crown EGB in much the same way
23 as the GSC does.

24 **MS REBSTOCK:** Do you generally accept the Crown EGB would start
25 with basically the same rulebook, including Part F?

26 **MS CALLINAN:** I think we do, although when we get to the
27 discussion on the risk of under-investment, there will be one
28 important qualification about how Part F would work; but, yes,
29 we do.

30 Just turning to how the decision-making process will
31 actually work: In terms of information flow, we just have a
32 few general points to add to what has already been said.
33 Decision-makers are obviously made to collect information in
34 order to make well-informed decisions. They'll collect that
35 from stakeholders, and there might even be an advantage to a
36 Crown EGB, where that information is commercially sensitive,
37 where it would be something that the stakeholders would be
38 more comfortable to release to an independent and neutral
39 party.

40 Despite the applicant's claims, there's nothing about a
41 voting process, in our submission, that will reveal more
42 information than any other process. A vote, at the end of the
43 day, just gives a "yes" or "no" answer to a proposal. If the
44 real information is why -- or the real question is why the
45 answer's "yes" or "no", then that won't necessarily be
46 disclosed from a voting process. And, to the extent that
47 voting processes are a valuable way of forcing people to make
48 a decision one way or the other, there's no reason why
49 indicative voting processes couldn't be used in a Crown EGB
50 situation.

Transpower

1 In terms of expertise -- the Crown EGB in our submission
2 is likely to be permanent -- it's likely to have a
3 considerable amount of expertise. You've heard what
4 Mr Thomson has to say about the ability to attract good people
5 to the board of the Crown EGB compared with the industry EGB,
6 because of the accountabilities. We should assume it will be
7 a Government agency competent of making good decisions.

8 Just turning on to the working groups issue, as I said,
9 we think that the Crown EGB would have working groups, and its
10 possible even that the Crown EGB would Chair some of the
11 working groups as in the NECA model, and so, have direct
12 access to information.

13 The Commission expressed a concern in the Draft
14 Determination that concentration of decision-making in the
15 Minister could lead to working group participants adopting
16 more extreme positions on proposed rule changes. Transpower
17 contests that point to the extent that, in our submission, it
18 will take more than just adoption of extreme positions to
19 persuade a Minister. The Minister, at the end of the day,
20 would need rational and persuasive arguments in order to
21 accept or reject a recommendation.

22 The Commission also credited industry participants with
23 making sensible proposals to the industry EGB in the knowledge
24 that they need to persuade the well-informed industry
25 colleagues to accept them, sort of a compromise solution,
26 thereby leading to better outcomes. I think NZIER put this
27 well when they said that was unlikely, given that the bottom
28 line, that certain sectors in the industry will have the
29 voting rights. If they have the numbers, then there's not
30 necessarily any incentive for them to have a considered
31 dialogue with the other parties in the industry and reach some
32 kind of sensible compromise solution.

33 Just turning now to what we consider to be the advantage
34 of decision-making by the Crown EGB in that this is something
35 that's already come up several times: In Transpower's view
36 the industry EGB is largely a process manager, and the reason
37 that we say that is simply because any significant rules are
38 going to need to go to a vote under the voting process.

39 But it's the industry EGB that's technically and
40 substantively accountable under the Act, so there's a
41 disconnection there, while the industry EGB is accountable to
42 the Minister. They're not the decision-makers. In our
43 submission, there's little point in holding accountable a body
44 that's not the ultimate decision-maker because it lacks the
45 powers that would go with those responsibilities.

46 **CHAIR:** Can I just ask you a question on that point. Have you
47 got a view then as to why it's been made -- what do they call
48 them, EGOs, accountable to Parliament under the Act
49 nevertheless. I mean there is some accountability obviously
50 seen there.

1 **MS CALLINAN:** There definitely is some accountability under the
2 Act, but the decision-making will still reside with the
3 industry, and that's the fundamental difference.

4 So, whilst the industry EGB will need to report to the
5 Minister, provide, agree performance standards and so on and
6 so forth, as set out in the legislation, the question is,
7 who's making the decisions? So, the actual industry body can
8 only be accountable, so far, if they don't get the vote.

9 **MS BATES:** I think I disagree with you. I put it on the table
10 because you say, little point in holding them accountable when
11 they're not the ultimate decision-maker. Well, in effect, if
12 Government sets the aims and objectives and outcomes, and
13 they're not met, the industry EGB will not survive, which
14 means the industry will lose its power, and that is a very,
15 in my submission, a very real accountability that you've got
16 there.

17 **MS CALLINAN:** You're right to the extent that, if the industry
18 EGB does not perform on a regular basis, and if the Minister
19 decides to trigger that power to basically put in a Crown EGB,
20 then you're right. In the long run they will be accountable.
21 But part of our submission is, what happens in the meantime?

22 We've been talking about the complexity of picking up,
23 say, the process of blocking pro-competitive rule changes. It
24 may be, some time there may well be a real time lapse between
25 those problems being identified, if they're identified at all,
26 and that process being triggered.

27 **MS BATES:** If they're identified at all; let's examine that. I'm
28 sure there'd be some people, that are not generators and
29 retailers, who would make it their business to identify some
30 of these things.

31 **MR ROBERTSON:** If I could comment; it seems to us that there's a
32 lot made of the ability of the Crown, the Government, to set
33 targets and objectives and hold the EGB accountable for those.
34 The reality is that, even at a most simple level inside a
35 relatively straightforward company organisation, setting
36 targets and objectives for the 12 months ahead is not an easy
37 exercise. I don't know if any of you have participated in
38 that.

39 **MS BATES:** Yes, you can be sure we have.

40 **MR ROBERTSON:** It's difficult to set them, and it's even more
41 difficult then to genuinely assess performance against those
42 targets, and you really have two choices: You can attempt to
43 genuinely assess performance against the targets, or you can
44 say that setting of the targets and my enforcement of them is
45 the thing and, therefore, you can make, if you like,
46 unilateral decisions as to whether the targets were met or
47 otherwise.

48 If you step outside of a pure company situation into an
49 industry situation, the complexity involved in setting those
50 targets is multiplied many-fold. It appears to us that the

1 process of setting the target itself will be critical. It
2 seems to us that one downside would be were we to end up, if
3 you like, going through the motions of setting targets for the
4 sake of setting targets when they're ill-informed --
5 ultimately ill-informed targets.

6 **MS BATES:** Can I just take that with you a bit further. How do
7 you think the EGB process is going to work? You don't think
8 there's going to be targets and outcomes identified in that
9 process?

10 **MR ROBERTSON:** Under the Crown EGB?

11 **MS BATES:** Yes.

12 **MR ROBERTSON:** I think there'll be targets there.

13 **MS BATES:** Won't you have the same degree of complexity and
14 exactly the same thing as what you're talking about?

15 **MR ROBERTSON:** The essence of our argument -- there was much made
16 of the difference between the two proposals in the Draft
17 Determination, and the essence of our argument is there really
18 isn't such a difference between the two. Setting targets is
19 going to be a vexed issue under both. I think that the
20 support claimed for the industry EGB approach whereby there is
21 accountability, and we have the agents of the Government able
22 to monitor performance on an annual basis, is asking a lot.
23 Our view is that there will be -- you have an environment
24 where the industry EGB is incentivised to make positive
25 assertions as to its effectiveness. It's beyond --

26 **MS BATES:** I understand what you're saying in that regard, yes.

27 **MR ROBERTSON:** So that, you have a Crown agency who's asked to
28 come in and review the assertions made by the industry EGB on
29 an annual basis and they're asked to say -- if I remember
30 rightly, they're asked to establish whether the assertions are
31 soundly based. That draws them into the subtleties of, and
32 complexities of the targets that were set in the first place
33 and the assessment of performance in the second place. I just
34 cannot believe that we're going to get any clear-cut decisions
35 emerge from that process.

36 **MS BATES:** So, just contrast that, will you for a moment, with
37 the process whereby the Minister advised by -- as is obvious,
38 will be advised by officials; how is that going to differ?

39 **MR ROBERTSON:** I think, in terms of the dynamics that you have --
40 it comes back to a point I made at the outset, that there is a
41 fundamental difference between an arrangement which is set up
42 to unambiguously pursue self-interest in the belief, the faith
43 that the pursuit of that self-interest will, in aggregate,
44 deliver the public interest and one where there's a positive
45 embrace of a Government policy direction and a, if you like, a
46 direct engagement on the success or otherwise of the pursuit
47 of that direction.

48 **MS BATES:** So if there was a direct embracing of the policy
49 statement, unadulterate, would you feel better about the
50 industry EGB?

1 **MR ROBERTSON:** Absolutely, we would.

2 **MR THOMSON:** Can I add something else? Your point about, if it
3 failed the Government would shift in with the legislator
4 model. I'm not certain. Professor Hogan made a very good
5 point that they might not do that. They may move into a far
6 heavier model. You know, the electricity industry amongst
7 consumers is not held in high regard at the moment and that
8 puts pressure on to, maybe, re-amalgamate.

9 The Minister has said twice in speeches that he has a
10 bad model that he can't fix. That is about putting the hydros
11 back together, right. And, I mean, you can't assume that, if
12 it falls over, you're going to go to the Crown EGB model and,
13 say, in three years time.

14 **MS BATES:** I don't necessarily disagree with you on that at all.
15 The point is that the threat of more intensive regulation or
16 supervision -- whether it be by way of a Crown EGB or
17 something worse, and depends on how you look at it, of
18 course -- is a very real constraint on the industry to try and
19 reach Government specified objectives, was the point I was
20 trying to put forward.

21 **DR SUNDAKOV:** Perhaps, if I could just comment on that. I think
22 you're absolutely right, that the threat of regulation will
23 exercise constraint. But I think it's like a nuclear
24 deterrent. The question is, when is it defective, and it's
25 certainly not effective if you use it all the time.

26 There's no doubt the threat of regulation will stop the
27 industry from doing anything that's extremely anti-competitive
28 or is highly visibly anti-competitive. I think the question
29 is, is it realistic to say that the threat of regulation or
30 the threat of Government coming in and disbanding the industry
31 EGB would stop a number of cumulative small-scale changes. I
32 think the answer is, no. These kinds kind of cumulative
33 small-scale changes are likely to go through precisely because
34 everybody will know that the Government will be very cautious
35 about using this ultimate threat over small things.

36 **MS BATES:** No, but it just depends whether it does have something
37 else in place, which we have been talking about, which is the
38 monitoring by way of setting objectives and assessing. Which,
39 you say, is unlikely to pick up the subtle changes that you
40 anticipate there will be in favour of the industry players and
41 against, say, consumer interests.

42 **DR SUNDAKOV:** I think, again, it comes back to, what is an
43 industry EGB? An industry EGB that is monitored in such a way
44 that will pick up these things, the industry EGB that is
45 unable to exercise its own voting powers to get through
46 relatively small things, the kind of things that are not
47 required to go back to the Commerce Commission, for example;
48 it is not an industry EGB, it's a Crown EGB.

49 **CHAIR:** Can I just ask another couple of other questions before
50 you move on. Assuming that the industry EGB is composed of

1 people who, for want of a better word, want it to succeed, I
2 think you're unlikely to take the job on unless you didn't.

3 Given also that, I guess notwithstanding Mr Robertson's
4 comments about the effectiveness of the monitoring body, there
5 would, it seems to me, be fairly strong incentives on that
6 industry structure to be able to get a performance agreement
7 agreed with the Minister, or an indicative performance
8 agreement and to satisfy the monitoring agencies.

9 I mean, Auditor-Generals aren't renowned for their
10 diffidence in commenting on performance or not. So there
11 would be some incentives to try and get that strategic
12 agreement performance measure sorted out given that the
13 fallback position is perhaps not as extreme as Mr Thomson
14 mentioned, but certainly in the first instance is a Crown EGB.

15 I would have thought that for the first year or two for
16 an industry body, there would be very strong incentives for
17 them to want to get it right so they weren't dismantled two
18 years later.

19 **MR ROBERTSON:** There clearly is an incentive to reach agreement
20 on the structure against which you're going to be - you know,
21 that the Crown is going to hold you accountable as an industry
22 EGB. I would say the incentives on the industry EGB is to
23 fight very hard to make that as soft and --

24 **CHAIR:** Permissive, if you like.

25 **MR ROBERTSON:** Thank you, "permissive". I was going to say
26 obscure or conceptual or abstract as you can. That's where
27 the incentive must lie, because you genuinely don't have the
28 ability in the industry EGB to exercise direct control over
29 the factors that will contribute to that. You can appoint
30 working groups, you can change working groups if they're not
31 delivering, you can set the agenda. But you can't squeeze out
32 of those working groups the decisions that you believe may be
33 necessary.

34 So that, yes, that's really a mechanical hurdle that
35 they have to get through; they know they have to agree that
36 and they know that they're going to end up in a dialogue with
37 the Auditor-General as regards performance, but the Auditor-
38 General takes many brave stands.

39 I've had some experience, not in their role, but in the
40 private sector auditing role and I know how difficult it is to
41 form objectively and factually based views as to performance.
42 It's very very difficult.

43 **CHAIR:** I accept your point. I've been on the other end of
44 Auditor-General reports too over the years, but that's another
45 issue.

46 But if you're going to get people on the EGB who want to
47 make it work and they know what they're talking about, which
48 I'm sure the industry will want to do that, then I guess there
49 is a trade-off to the degree to which they're prepared to take
50 a soft option or they're not. To some degree you're in the

1 hands of the people on the board.

2 **MR ROBERTSON:** I guess my argument is simply that the incentive
3 for those people on the board, given their lack of direct
4 ability to control outcomes, is to seek that softer option
5 rather than the other option.

6 **MS CALLINAN:** Just pulling it back to the broader point; all
7 we're seeking to establish is that the decision-making process
8 under the industry EGB is not going to be so different from
9 the Crown EGB other than this issue of incentives that we keep
10 coming back to. So, in terms of the fact the Commission has
11 seen comparative advantage in decision-making under the
12 industry EGB, that's where Transpower wishes to draw that
13 closer.

14 **CHAIR:** Where Dr Sundakov was too.

15 **MS BATES:** Assuming that on an industry EGB you did get people
16 who had had at heart the desire to put Government policy and
17 objectives into play, then I suggest that their incentives
18 would be for the outcomes and steps not to be soft and
19 woolly -- which I think is the point you're trying to say --
20 so you can't actually measure them, but to be proper ones so
21 they can use that as a way of getting the industry to come to
22 the party.

23 **MS CALLINAN:** If I can respond to that. Even if that is right,
24 that makes the industry EGB comparable to the Crown EGB,
25 except the Crown EGB has a distinction that the ultimate
26 decision-maker is the Minister rather than the industry
27 through the vote. So, we just come back to this question of
28 whether it's an advantage or a disadvantage for that self-
29 interest to be ultimately the deciding factor.

30 **DR SUNDAKOV:** I think also in a number of areas, even if industry
31 EGB members want to give direct expression to Government
32 policy, they actually may not have any procedural means of
33 doing so to the extent that the Rulebook describes a very
34 specific process of how a decision passes through the industry
35 EGB and goes to the industry vote, and the vote comes out with
36 a particular result. There's a very limited opportunity for
37 the board members to step outside the process.

38 **MS BATES:** I agree with that. But it would be pretty obvious to
39 a Minister if recommendations kept being put up by the
40 industry EGB and voted down by the industry, wouldn't it?

41 **DR SUNDAKOV:** But I think again, we're not talking about extreme
42 situations. I think there's -- no doubt extreme situations
43 would be stopped. I think also --

44 **MS BATES:** I'm not talking about extreme situations, I'm talking
45 about a pattern developing. I'm talking about the cumulative
46 decisions. If there was a pattern developed of the so-called,
47 if it were, objective industry EGBs putting up recommendations
48 and the industry kept on stymieing them, don't you think the
49 Minister would take notice of that?

50 **DR SUNDAKOV:** We're talking about exceptionally complex issues,

1 as our discussion on FTRs have shown, and other examples as
2 have been mentioned. There are many sides to every possible
3 example. It would be exceptionally difficult for the Minister
4 in every case to decide what the EGB is proposing is the right
5 thing or wrong thing.

6 **MS BATES:** I specifically wasn't talking about in every single
7 case. I'm talking about the things you people have mentioned
8 yourselves, which is subtle changes, but a pattern of changes
9 being in a particular direction.

10 What I'm putting to you is that if that would be
11 transparent, the Minister would be able to see that, and
12 particularly if you did have an objective industry EGB.

13 **MR ROBERTSON:** If I could comment; perhaps one perspective on
14 this is the time it takes for this recognition to occur. We
15 started out in 1996 with a market design that was said to lead
16 the world, and we've seen over the ensuing years that lead
17 diminished and was surpassed by other jurisdictions who have
18 somehow managed to find a more expeditious way of making
19 decisions.

20 So that, in addition there's an initial -- our argument
21 would be that there's a significant recognition lag before the
22 Crown would recognise serious problems. Not only that, there
23 then is the requirement to adverse reports from the agencies
24 monitoring it on the behalf of the Crown, so that's another
25 two years.

26 **MS REBSTOCK:** I wonder about this lag because the Minister or the
27 Crown will continue to own the vast majority of these
28 businesses that we're talking about. I believe the Minister
29 routinely meets with industry leaders, from what we've been
30 told, and I don't get the impression that anyone is very shy
31 about putting forward their views.

32 So, it seems that the opportunity has always been there.
33 The Minister, if not for any other reason than the ownership
34 interest, has had a pretty open door to hearing the complaint.
35 I wonder how sustainable that position is.

36 **MR ROBERTSON:** Perhaps that speaks to the complexity of the
37 issues that the Minister hears from. It also certainly speaks
38 to the suggestion that Transpower would have greater priority
39 to the Minister's ear than any other party, because I think
40 we've ended up on many issues effectively counterbalanced.

41 **MS BATES:** I think there was a view -- .

42 **MR THOMSON:** You can't have it both ways. You can't have the
43 generators independent and being co-ordinated by the Minister,
44 and that is what you're trying to say. It just doesn't
45 happen. You're better to bring it all out in the open and
46 make it happen properly. The industry EGB hides it all. It's
47 all behind the door, and that's not the way to do things. I
48 mean, that's what Alex has been making the point about.

49 **MS REBSTOCK:** I just want to take you to a document that was on
50 the Transpower website in July of 2001, which was your

1 submission on the governance project package, and I just want
2 to make sure we're getting to the heart of your concerns. You
3 talk in there about -- it says something to the effect that
4 Transpower supports the proposed governance arrangements and
5 market rules which should ensure that market driven
6 investments are made where possible and that economically
7 justified investments are made under conditions that provide
8 appropriate incentives and assurance of economic cost
9 recovery.

10 You go on to say that, to ensure this outcome is
11 achieved in all the circumstances will require on occasion the
12 EGB board to exercise executive authority in respect of
13 investment decisions. And you go on in the document to talk
14 about what the circumstances might be in which that board
15 would need to be able to act in the public interest.

16 But in reading that document it really does seem to come
17 down to this issue about executive power, and the reason I
18 come back to this is, you seem in that document to acknowledge
19 that there are some benefits to be had by an industry led
20 process, but you heavily qualify it in terms of the conditions
21 under which it could be realised. It does seem to keep coming
22 back to this issue about implicit accountability to the Crown
23 and the decision-making process itself in terms of who has
24 final authority. Is that a fair interpretation of your
25 position?

26 **MR ROBERTSON:** I think it is. I think that's what's embodied in
27 the four core characteristics that Mr Thomson pointed out in
28 his opening remarks, I can't specifically recall what took
29 place between May 2001 and July. I suspect that was our
30 response to the first draft of the Rulebook, or maybe even the
31 subsequent iteration of the Rulebook.

32 **MS REBSTOCK:** I'm just trying to make the point that at that time
33 you seemed to see some advantages, at least in part, to the
34 industry led processes around the Rulebook in the proposal
35 with some serious, though at the time you called them "minor"
36 modifications I think. But nevertheless, there were some
37 concerns about some of it. So, you must have seen some
38 advantage to an industry process that would lead you to say,
39 with some modifications you could see benefits in an industry
40 led process.

41 **MR ROBERTSON:** This was a process which even then, I think, had -
42 if I remember correctly, the first draft of the Rulebook that
43 was issued around June of 2001 was very close to that which -
44 the high level outline that had emerged from the inquiry into
45 the electricity industry.

46 **MS REBSTOCK:** So it shifted away from that, is what you're saying?

47 **MR ROBERTSON:** Yes, and at that point it was still describing
48 itself as mandatory; it had executive decision-making vested
49 in the Governance Board on the matters that we considered to
50 be critical. I think those are the essential elements of the

1 four characteristics that we've said we would look to see.

2 So, if the industry was able to produce an arrangement
3 that was mandatory, and openly mandatory for those matters
4 that we consider to be fundamental, we describe that as - we
5 had a phrase that we used, the wholesale physical market,
6 which was meant to capture all those multi-lateral issues,
7 that it had to be agreed on behalf of all the common interest.
8 Then we were happy with that. In the absence of that, as to
9 the counterfactual, the Crown EGB looks distinctly preferable
10 to us from the current arrangement proposed.

11 **MS REBSTOCK:** I put the question to you because, when you read
12 that document, you seem to have moved a long ways from
13 suggesting that minor limited modifications could fix this
14 regime to one where you are just coming right out and saying
15 that a Crown EGB would be preferable.

16 **MR ROBERTSON:** My comment is, you need to interpret that letter
17 in the context of the form of Rulebook that was on the table
18 at that time.

19 **MS REBSTOCK:** I appreciate that. That helps, because we have seen
20 quotes from the document, and you can look at the document and
21 not necessarily understand the context at the time.

22 **MS CALLINAN:** If I could just then return to 1.8(c) of the
23 submission, and I just want to pick up on some of the points
24 that haven't already been covered off in this discussion. We
25 pose the question, how does the fundamental issue of
26 accountability and self-interest impact in practical terms?
27 Our submission here says, possibly very little difference of
28 uncontroversial rule changes, but where rule change is
29 controversial we are either going to be winners or losers;
30 then that is where, in Transpower's submission, it would be
31 preferable to have a Crown EGB with ultimate accountability
32 and decision-making.

33 Just to draw in a point that the applicant made; they've
34 responded by identifying a number of pro-competitive rule
35 changes. Transpower will come to those rule changes in the
36 next section and explain why, in our submission, those rule
37 changes do not demonstrate why industry self-interest will not
38 prevail.

39 The one point that we wanted to end on in this section
40 was a slight, what we see as, inconsistency in the
41 Commission's position and maybe Mr Sundakov can speak to this.
42 Because, where the Commission has seen self-interest as a
43 positive factor in terms of yielding a good quality decision-
44 making process, it's also seen self-interest as a negative in
45 terms of the potential for blocking pro-competitive rule
46 changes. In our submission there is an inconsistency between
47 that.

48 Alex, do you have anything you want to add to that?

49 **DR SUNDAKOV:** I think it just goes to the general point I was
50 making before. You have to look at quality of decision in

1 toto rather than -- I think it's sometimes -- obviously, when
2 you're dealing with something as complex as this, it helps to
3 break it down into components, but equally the breaking down
4 into the components, particularly the way it's been done in
5 the Draft Determination, I think, creates the risk of looking
6 at things in isolation; not seeing the big picture.

7 If you're assessing the quality of decision-making you
8 have to look at it in the context of what is the overall
9 likely outcome, which way is going to drive decisions. It
10 seems to me that self-interest cannot be a benefit in one area
11 and a detriment in another area. It either colours the whole
12 decision-making process compared to the counterfactual or it
13 doesn't colour the process.

14 **MS REBSTOCK:** I wonder if that's right. I mean, the vast
15 majority of rules that might be made, maybe 90 % of them,
16 self-interest will result in nothing offensive, and you can
17 give credit to that. But for the 10 % that doesn't, or the
18 5%, or 1%, you could have some detriments or you could assign
19 weight and it's true you get some net amount but there is some
20 benefit and some detriment, it seems.

21 **DR SUNDAKOV:** But for the vast majority of decisions that are
22 going to be relatively uncontroversial and where self-interest
23 is a reasonable proxy for quality of decision, it's very
24 unlikely the decisions would differ from the proposal and the
25 counterfactual. It's only where the two differ where the
26 issue comes up, and they only differ in the issue where self-
27 interest is a risk.

28 **CHAIR:** Yes, I mean, it's a question of how you weight it, but
29 logically following that conclusion the Crown EGB would
30 necessarily be structured for the exception rather than the
31 rule.

32 **DR SUNDAKOV:** I think we're saying the same thing. I think the
33 Crown EGB on uncontroversial decisions is likely to pretty
34 much mirror anything the industry EGB produces, as is common
35 in most areas of Government decision-making.

36 **MS REBSTOCK:** If you accept the proposition that there's no
37 information or decision-making advantage of the industry over
38 the Crown; I mean, it's all premised on that.

39 **DR SUNDAKOV:** It comes back also, I think, to the point we made
40 about what processes the Crown would use. The Crown's capable
41 of using all the processes that utilise information.

42 **MS CALLINAN:** If I can just continue. We just want to make some
43 brief response s to some of the specific points in the
44 applicant's argument at paragraph 1.9.

45 The applicant has claimed that there are greater checks
46 and balances in the decision-making process under the proposed
47 arrangement and yet it hasn't, in our view, explained how the
48 different levels will actually result in better quality
49 decisions. More procedural levels might in fact result in
50 more opportunities to block pro-competitive rules.

1 The second point is that the applicant has characterised
2 Ministerial decisions as possibly arbitrary, and in fact I
3 think it's accepted the Act explicitly provides decisions by
4 the Minister that, apart from the Crown EGB recommendations,
5 have to be publicly justified by publication in the Gazette.

6 **CHAIR:** "justified or notified" is the word.

7 **MS CALLINAN:** "notified". I guess I'm reading into "notified"
8 "justified" as a matter of implication.

9 **CHAIR:** Which is under Section 26 at the moment, those statements
10 are notified by Gazetting or tabling in the House. I don't
11 think that particular provision has been seen as a
12 justification for a statement of Government policy. I haven't
13 got the Act in front of me.

14 **MS CALLINAN:** I have now got the Act in front of me. The
15 relevant section says: "if the Minister decides not to act on
16 an EGB recommendation to substantially depart from an EGB
17 recommendation or to defer making a decision on an EGB
18 recommendation the Minister must publish a notice in the
19 Gazette stating his or her decision and explaining the reasons
20 for it and where the copies of that explanation can be
21 obtained." So, it is something more than the normal Gazetting
22 process.

23 **CHAIR:** Point taken.

24 **MS CALLINAN:** But I come back to one of the points that was
25 raised before lunch, because the counter-argument to that was,
26 well, in the industry EGB will the Minister still be putting
27 pressure, perhaps behind the scenes, on the players to ensure
28 that they live up to the objectives of the GPS for instance?

29 Maybe I can just ask Peter to comment on the relative
30 merits of that having been done transparently through the Act
31 or through other means.

32 **MR ROBERTSON:** Well, to a degree it feels as though we've
33 traversed probably all of this ground, but just in an attempt
34 to summarise it, it seems to us what we're looking at here is,
35 we're trying to distinguish one from the other.

36 Our argument is that in many respects it's too hard to
37 call. In other words, there is not a significant difference
38 between one and the other. The prospect under the industry
39 EGB of rising discomfort with the trends actual outcomes being
40 achieved through the industry would elicit a response, it
41 seems to us from interaction so far, that it would elicit a
42 response from the Minister.

43 The phrase "slippery slope" sort of springs to mind,
44 because for a Minister to be able to respond effectively, he
45 will no doubt be working with his officials. The officials
46 will be getting involved. When they get involved, we're left
47 with a question as to how that involvement might be manifest.

48 The EGB, the board, presumably would be concerned and
49 would seek to respond in some way because I don't think it's
50 critical to our analysis, that we're certainly not wanting to

1 paint a picture of a board which is hell-bent on defeating the
2 Government in this respect, so it's quite well within the
3 scope of our analysis that this board is indeed positively
4 engaged and looking to produce some useful outcomes. The
5 question is, how they then do that. Their resources are
6 limited in the way in which they can do that. They can
7 exhort, they can change working groups.

8 The end result to us seems to be a process that almost
9 is, from the outset, destined to reduce to the back door the
10 whispers and -- what was the other -- the whispers and the...?

11 **MR CURTIN:** Phone calls.

12 **MS BATES:** What? I didn't hear it.

13 **MR ROBERTSON:** Nor did I actually. Alex, what was it?

14 **DR SUNDAKOV:** Phone calls.

15 **MR ROBERTSON:** Whispers and phone calls. It just seems to be an
16 environment which will encourage that means of exhortation
17 and, "come on, let's play the game here", type of approach as
18 distinct from the Crown EGB where the process, it seems to us,
19 will almost inevitably be out there on the table, that --

20 **MS BATES:** The suggestion has been that you're going to still
21 have your whispers and whatever with a Crown EGB where it
22 comes to, what form are the recommendations to the Minister
23 going to take. So, if you follow my meaning, whilst it can
24 seem more straightforward, there's still the potential there
25 of course for exactly what you're describing to take place.

26 **MR ROBERTSON:** I think that is right. The question is one of
27 degree, and we see a virtue in the directness and openness of
28 the Crown EGB approach as distinct from the industry EGB
29 approach where, absent other direct tools, that seems to us to
30 be about all that's left.

31 **MS BATES:** The essential difference seems to be, and this is one,
32 what you say as against the applicant saying that what it
33 fears with the Crown EGB is insufficient weight being given to
34 the needs and concerns of the industry. For example, it would
35 be required to pay for further investment in the grid without
36 having sufficient say. So, it's -- I mean, both concerns are
37 about the degree of influence one will have. Do you agree?

38 **MR ROBERTSON:** I think I understood your point, yeah, yep.

39 **MS BATES:** Well, do you think the applicant is at all justified
40 in having the fear that it's not going to get -- it's going to
41 be required to pay without having sufficient say?

42 **MR ROBERTSON:** I think that touches on the argument that supports
43 the approach of self-interest, which is justified on the basis
44 that those who bear the costs and enjoy the benefits should
45 make the decisions. It was our experience in the various
46 working groups that took place that the consumers tried at
47 almost every point to establish the validity of their own
48 view, that they bore ultimately all of the costs and hoped to
49 enjoy some of the benefits of many of the decisions that were
50 taken, and that view was not supported, it was invariably lost

1 in a voting process that relied on simple majorities. So, I
2 think that -- I've lost my thread.

3 **MS BATES:** Well, I think you're saying that people who pay don't
4 always get enough say regardless of what you do.

5 **MS CALLINAN:** I think structurally what we're saying is, the
6 industry still will be represented by working groups anyway;
7 so, to the extent that's a concern, it ought to be addressed
8 by working group structure under a Crown EGB model. It comes
9 back to the very first point we made in this section, that
10 it's not appropriate to characterise the Crown EGB as some
11 central planner with having no regard to industry
12 stakeholders. That just doesn't seem to be realistic.

13 **MS BATES:** Well, it is required to consult -- the EGB itself, is
14 required to consult. That isn't quite the same -- as much
15 power as having to vote on something, of course.

16 **DR SUNDAKOV:** I think in this context, if I may, it's useful also
17 to reflect on the role of the Auditor-General, and to what
18 extent the Auditor-General is able to pick up on any
19 divergence between the Government's policy objectives and what
20 the industry EGB is doing. I think it's highly unlikely, it
21 seems, the way that the Auditor-General works, that the
22 Auditor-General would hold the board responsible for anything
23 that's outside of its normal pursue of powers, and to the
24 extent that there are some outcomes of certain votes which are
25 the votes that are perfectly legitimate within the rules, that
26 these outcomes may be not exactly what the Government wants.
27 It's very hard to see how the board could be held accountable
28 for that by the Auditor-General. The Auditor-General will be
29 aiming to ensure that the processes that the board follows are
30 in compliance with the objectives.

31 **MS BATES:** I suppose I go back to where I went to before on in
32 this. Ultimately it will do that, it will make the board
33 accountable by putting it out of existence.

34 **DR SUNDAKOV:** I guess what I'm questioning is whether the
35 Auditor-General would even have the institutional capability.
36 The Auditor-General would have to pass judgments that the
37 outcome of votes are anti-competitive. It would have to jump
38 into areas that it clearly sees outside its purview.

39 **CHAIR:** I think the Auditor-General these days is engaged in a lot
40 more, if you like, generic assessment as against looking at
41 approvals, and does X match Y. So, it would depend again, I
42 guess, on who was advising the Auditor-General.

43 Just before you move on, one other point getting back to
44 Mr Sundakov and his whispering phone calls, or however you
45 described them, it does seem to me -- and the point that was
46 made by the applicant very strongly -- that this process in
47 relation to briefing the Minister that has gone on, has been
48 fairly widely reported, and indeed the Minister on at least
49 half a dozen opportunities that were quoted in various
50 speeches he's given has also been concerned to make sure that

1 people know where the issues are going publicly.

2 So, I don't see necessarily that the industry EGB
3 interface with the Minister is going to be behind closed
4 doors. I think this Minister anyway has, as I read it, made
5 it fairly clear as to what's happening and what he expects.
6 That's only as a -- reading the newspapers basically. So, it
7 seems to me that it may not be quite the issue you argue it
8 is.

9 **DR SUNDAKOV:** I think it's very relevant. I think that actually
10 goes directly to what I think we're saying. I think what
11 you've just described is the fact that the industry has been
12 quite explicitly and quite positively pushed and prodded along
13 by the Government, even though that was done in the context of
14 a series of industry led processes but with the Government
15 playing a very intense and very involved role in this.

16 I think what I'm hearing you saying is, the industry EGB
17 will continue operating in exactly the same way, that there
18 will be ostensibly an industry process, but the Government
19 continuing to play a very detailed, very positive, and very
20 explicit role in pushing it in the --

21 **CHAIR:** I probably wasn't going quite that far, but I was saying
22 that, up till now, going back to Mr Caygill's inquiry, the
23 whole process has been fairly open so where there may be
24 issues that are just above the routine issues you discussed
25 earlier, I would have thought it has been set fairly well by
26 precedent that that wouldn't be a closed door interface with a
27 Minister type situation on the part of an industry EGB because
28 it's been mainly public so far.

29 **DR SUNDAKOV:** I think that's right, but I think this kind of
30 ongoing Government involvement, very very explicit, very acts
31 of Government involved with the industry EGB, to me, doesn't
32 describe the proposal in the proposed industry EGB, because
33 the benefits that were claimed under the proposal rely
34 entirely on a much greater distance between the Government and
35 the industry.

36 **CHAIR:** I'm just picking up your point, on the crunch issues
37 there may be a transparent relationship; for 95%, as you've
38 said, no need for it anyway under the other model, that's
39 all.

40 **MR THOMSON:** At the moment there's two parallel processes going
41 on. There's the formation or there's the industry EGB.
42 Separate to that there are about four bodies in the industry,
43 Transpower being one of them, that every two months have to
44 report on specific issues that the Minister wants solved.
45 Believe me, he's driving them, right. I think, as Alex has
46 said, there's not that much difference between the two.

47 But, working with the direct instructions from the
48 Minister, you get a far clearer position than going through
49 the industry EGB which shelved all the work and said "We can't
50 do it, get the NZEM and Transpower, and here goes the

1 allocations, you go and do them guys", and I think that shows
2 what's going to happen under this EGB, there's going to be a
3 failure and you're not getting a clean-cut result which will
4 lead to trouble.

5 **MS BATES:** What about working through the Crown EGB, because it
6 doesn't seem to be envisaged that the industry works directly
7 with the Minister under that model; the model, in legislative
8 terms, envisages that the industry will work with the EGB and
9 that the EGB will consult with the Minister.

10 **MR THOMSON:** Yes, I know that's what the model says, but life
11 doesn't work like that. I've had phone calls a lot of times
12 about --

13 **MS BATES:** Whispering ones?

14 **MR THOMSON:** No, usually bellowing ones, "fix something". Sorry
15 but --

16 **MS BATES:** No, it's interesting to talk about it because we are
17 interested in what really happens as opposed to what might be
18 written on a piece of paper; but you are advocating for a
19 Crown EGB?

20 **MR THOMSON:** Yeah, because there's more control.

21 **MS BATES:** Yeah, I understand that. But are you envisaging that,
22 you know the way that you're working with the Minister, you
23 say there's four main industry groups reporting to the
24 Minister directly every couple of weeks.

25 **MR THOMSON:** Couple of months, every month.

26 **MS BATES:** Whatever it was, but on a regular basis, and you seem
27 to say that it's very good to have that direct relationship
28 between the Minister and the four industry players you're
29 referring to. Do you envisage that that, in reality, will
30 continue with the Crown EGB?

31 **MR THOMSON:** With a Crown EGB, no. Because I think the Crown EGB
32 will have authority to make decisions, and they will make
33 them.

34 **MS BATES:** But it doesn't. It's the Minister who does.

35 **MR THOMSON:** Yes, but they will make the recommendations to the
36 Minister and he's got to publicly say if he disagrees with
37 them and say no, so 98% will go straight through. Practically
38 that's how it will work. You'll get a far clearer process;
39 that's the way it --

40 **MS BATES:** I really want to know why you think that process will
41 be far clearer working with a -- will it be clearer than
42 working directly with the Minister as you say you do at the
43 moment?

44 **MR THOMSON:** I think that the Crown EGB will be better informed
45 than a Minister, and I think they will have executive powers
46 to make -- they'll make a decision and you'll know where you
47 are. I think, to that extent, it will be better than working
48 directly with a Minister one-to-one behind the scenes, and I
49 think if you've got an industry EGB what I've seen is, the
50 working groups take a lot of time and the voting structures

1 are damn complicated, and you won't -- you'll get stalemates;
2 a lot. I mean, that's FTRs, that's exactly the sort of thing
3 that's happened. There's no nobody there to make a decision.
4 That's what I was trying to get across in my initial thing.
5 You might think I'm just a line manager, but I think it's far
6 better to have decisions made; I'm a poor innocent.

7 **MS BATES:** Yes, I'm very persuaded by that, Mr Thomson.

8 Let's go back: So do you think the Minister -- the
9 reality, no matter what's written in that statute, the
10 Minister is the ultimate decision-making power, you think the
11 reality of it is that the Crown EGB will be making the
12 decisions, albeit de facto, and that the Minister won't get
13 the officials to advise on whether the Crown EGB's got it
14 right or not, do you think it will just directly take what the
15 Crown EGB says as being the right way to go?

16 **MR THOMSON:** He'll get advice from his officials, but his primary
17 source of information is going to be that Crown EGB. I mean,
18 that's what will happen. I mean, I think you could look at;
19 there might be a parallel with CCMAU and State Owned
20 Enterprises, and the Minister of SOEs and the CCMAU as an
21 advisor, and the Minister generally takes the chairman's
22 advice. That's what I've seen.

23 **MS CALLINAN:** Just to draw it back, what we're really just trying
24 to say, in our view there is not going to be a great deal of
25 distinction on a practical basis between the Crown EGB and the
26 industry EGB in terms of the way these decisions will be made.

27 **MS BATES:** I have to say, that's not what I'm hearing from you.
28 What I'm hearing from you is, there will be a great deal of
29 distinction in the way the decisions are going to be made.

30 **MR THOMSON:** I'm a firm believer in clear lines of
31 accountability, so you can pin results on people and you give
32 them the authority to do things. I run a process organisation
33 at the moment and I've run a functional organisation, it's
34 very similar stuff, and with a process organisation you've got
35 to have a very strong management team that interfere all the
36 time, and you can't do that under the industry EGB. I can't
37 see where the board can interfere when they see blockages.
38 They can't go in and say "look, you silly so and so's, fix it,
39 give me the arguments, do that".

40 **MS CALLINAN:** I didn't mean to oversimplify that.

41 **MS BATES:** No, no, I was just being frank with you in saying that
42 I did discern a difference.

43 **MS CALLINAN:** There will be differences where we're saying that
44 there is not going to be a significant difference is in the
45 quality of information flows, because that quality of
46 information flow seems to have been one of the differences
47 that the Commission focused on in reaching the view in the
48 Draft Determination, that there were advantages to the
49 industry EGB process.

50 So, what we're trying to draw out with explaining how we

1 see the Crown EGB would work is that on that factor, in terms
 2 of quality of information flows and accountabilities, we think
 3 that there will be no difference in terms of quality
 4 information flows, they should both be good, and in terms of
 5 accountability we see the Crown EGB model being better for the
 6 reasons that Mr Thomson's just explained.

7 So, just to come back to where we were in the
 8 submissions, 1.9 and paragraph C, we just want to briefly
 9 address a point that the applicant made. The applicant has
 10 submitted that the Government has already expressed a view,
 11 and I quote, "as to whether the industry or a regulator is
 12 most likely to maximise social welfare".

13 Our point on this is, it overstates what the Government
 14 has said. That clearly the Government prefers industry
 15 solutions, that doesn't seem to be controversial. That said,
 16 in the GPS itself, that industry solutions are preferred where
 17 possible.

18 The point we wish to make is, it's the Commission not
 19 the Government that is required to determine and, hopefully,
 20 as a result of this process, has the evidence to determine if
 21 the specific arrangement maximises social welfare compared to
 22 the counterfactual. So, to that extent it is interesting what
 23 the Government has said and, no doubt, that should be factored
 24 in somewhere, but it's not the case, in our submission, that
 25 they've said that this industry solution will maximise social
 26 welfare.

27 **MS BATES:** There's a difference between an industry solution and
 28 a particular industry solution. I think the Government has
 29 made it clear it prefers an industry solution; not necessarily
 30 this particular one we're evaluating.

31 **MS CALLINAN:** Yes, and that is in part my point; that to the
 32 extent any weight can be given to what the Government has
 33 said, one would assume that it favours an industry solution
 34 and one that could -- would comply with the Commerce Act and
 35 obtain the authorisation which is being sought in this case.

36 Point D I'll just refer you to. There were several
 37 parts in the applicant's conference notes where they made
 38 comments in relation to Professor Hogan's evidence, and I
 39 don't intend to take you through those, but we've just cross-
 40 referenced in paragraph D the parts of Professor Hogan's
 41 transcript where, in our view, he's dealt with the issues
 42 raised by the applicant in its conference notes.

43 That is the end of section 1. I'm sure that section 2 -
 44 - well, actually, I won't even say that section 2 will be
 45 shorter because it's a very substantive section. It's the
 46 section on pro-competitive rule changes. This is, of course,
 47 a critical issue and I'll start briefly in paragraph 2.4 by
 48 saying that there are other submitters who've made good points
 49 on this that Transpower would like to refer to. PowerCo, in
 50 the submission that we've quoted, have said in short the

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1 voting entitlements under the proposed arrangement entrench
2 supply side dominance, and a little further on, the result
3 will almost certainly be less competition, less innovation,
4 less efficiency and higher prices in generation and retail of
5 electricity.

6 Trust Power's made submissions along the same lines, and
7 we note that the supporters of the applicant's view on this
8 are all large vertically integrated retailer generators with
9 arguably considerable market power.

10 Just to go through Transpower's submission, because
11 we've broken this into a number of different sections -- 5
12 sections. We're going to address the points in this way.

13 First of all, we're going to go through some of the
14 points made in the earlier written submission addressing why
15 Transpower considers there's likely to be a failure in the
16 arrangement to address pro-competitive -- to develop pro-
17 competitive rules.

18 Secondly, the Commission in the Draft Determination
19 requested us to give examples in the current arrangements of
20 pro-competitive rules failing to develop and Transpower will,
21 in that regard, talk about FTRs in particular.

22 The third step in this part of the submission is to
23 analyse or respond to the analysis of the NZEM Rules given by
24 the applicant and Transpower will demonstrate that there has
25 been a limited development of pro-competitive initiatives, and
26 the examples in this category that again Nicki Crauford will
27 speak to are real time pricing and demand side participation.

28 Also in response to the applicant's submission,
29 Transpower will explain why it considers that the industry EGB
30 will not improve on the NZEM track record of promoting pro-
31 competitive rule changes and, finally, in response to the
32 applicant's allegation that the counterfactual contains its
33 own anti-competitive propensity vice, NZIER will talk to the
34 issue of transmission provider incentives and opportunities to
35 influence a Crown EGB and demonstrate, in our submission, that
36 this is not a realistic risk in the counterfactual. On that
37 point, to supplement what NZIER will say, one of Transpower's
38 General Managers, Kevin Mackey will give a practical example
39 in relation to generator connection to the grid.

40 So, that's the structure of this section but, no doubt,
41 questions will come in on all areas at once. First of all,
42 just the theoretical points or the straightforward points on
43 the failure to develop pro-competitive rules. Vertically
44 integrated generator/retailers have market power at the moment
45 and our thesis is, they're likely to act to protect that
46 power. In practical powers NZIER has pointed to the problems
47 caused by the industry incumbents potentially using the
48 Rulebook to delay new entry in an environment where
49 electricity prices are on the rise, and Mr Thomson referred to
50 that as well.

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1 Transpower's position on this, as I've said, is
2 supported by other submissions; even the applicant concedes
3 that there are risks of supply side misuse of market power.
4 The applicant relies on sanctions built into the arrangement
5 to reduce the risk. I think those are probably some of the
6 things we've already been talking about. They refer
7 specifically to the transparency of the process under the
8 industry EGB and the potential for review under the Act.

9 Transpower submits that those --

10 **MS REBSTOCK:** Can I just stop you for a second. The very first
11 statement that you made, I understand the point about what
12 you're indicating will happen under the Rulebook in the
13 future, but you start off with a point about the vertically
14 integrated generator/retailers having market power at the
15 moment. That they're likely to act to protect that power, and
16 I just want to come back to the earlier discussion because I
17 actually thought I heard your advisors suggesting that maybe
18 there isn't really all that much power held by those groups at
19 this time. So, can we just get some clarity on that?

20 **DR SUNDAKOV:** I think that it's -- what we're talking about is
21 that clearly there's some competition in this market. The
22 question is, on the continuum, from a lot of competition to
23 very little competition where we're likely to be. It seems to
24 me that there is -- while competition is present, there's also
25 sufficient market power. You can see it in a variety of
26 things that are happening in this market. Some of the market
27 power is localised, it's not market power that's available
28 everywhere nationally, but there are some modes where there's
29 a significant degree of market power present. The swapping of
30 consumers without consumers' explicit agreement is an
31 indication of the degree of market power. You wouldn't expect
32 Burger King or McDonalds to swap you around.

33 **MS REBSTOCK:** Do you expect to find that New Zealand has one of
34 the highest switching rates of customers across economies for
35 the market that isn't competitive?

36 **DR SUNDAKOV:** There was for a period of time, but what you're
37 seeing now is the industry congealing to regionally dominant
38 retailers. I think that's the point that Mr Heaps made.

39 **MS REBSTOCK:** Do you have any evidence to support that? That
40 they're switching barriers or switching has slowed down? I
41 know that customers were exchanged, but do we have evidence
42 actually that there is lessened competition in these markets?

43 **DR SUNDAKOV:** I don't have numbers at my fingertips, but I can
44 certainly go back and find them. From the work that we're
45 recently doing on this market we have picked up, apart from
46 large scale customer switching where retailers exchange
47 customers, we picked up a reduction in the number of switches.
48 Maybe you have more direct information Bill.

49 **MS REBSTOCK:** The reason I keep coming back to this, there's a lot
50 of allegations about limited competition in these markets now.

1 That might tell us something about what might happen under the
2 Rulebook. We kind of need to have a good understanding of our
3 starting point so we can come to a view on what the likely
4 impact of the Rulebook is, and I haven't seen any concrete
5 evidence of this limited competition in these markets. I do
6 think it's important to our -- you know, we can't agree where
7 we're starting this analysis on in terms of market analysis.
8 We have trouble then moving forward. So, if you've got
9 evidence of reduced competition in these markets at the moment
10 then we would be interested in providing it.

11 **DR SUNDAKOV:** Certainly. I just don't have the numbers at my
12 fingertips, but certainly the exit of independent retailers,
13 the re-alignment of retail along regional lines, an alignment
14 of retail with generation, to me, is an indication of
15 reduction in competition.

16 **MS REBSTOCK:** Have you actually looked at those different regional
17 markets and established whether the extent of competition in
18 most of them -- you might see some alignment, but it doesn't
19 mean there's not nevertheless competition within each of those
20 regions. Have you looked at those regions and established
21 that?

22 **DR SUNDAKOV:** There's some regions where there's virtually no
23 alternative, where one retailer has overwhelming market share.
24 As I say, I just can't remember the --

25 **MS REBSTOCK:** I'd like you to provide the evidence to us. I think
26 one of your colleagues wanted to add something?

27 **MR HEAPS:** We will be able to bring information on switching over
28 a period. I recall looking at the figures and there is some
29 confusion because of the problems with customer switching and
30 back logs. The figures, got to interpret them. But we can
31 provide those and I think what you'll find is certainly the
32 number of customer switching has decreased over time.

33 There's also, I think, evidence from -- I pointed out Te
34 Papa and the reverse auctions. But certainly we take the Bay
35 of Plenty region, Norsca Skog and Carter Holt Harvey were
36 certainly having difficulties getting contracts, hedge
37 contracts in the Bay of Plenty region, but Kawerau now.

38 Now, a lot of that was because they said constraints
39 into the area were causing the prices and the unavailability
40 of hedges -- other retailers couldn't come and sell them a
41 hedge in that area because of the high price of the high nodal
42 prices and their inability to manage those. But the
43 consequence of that is that there was only really one
44 generator that could offer a hedge in that area.

45 **CHAIR:** It was put to us by, whether it was the same generator
46 I'm not sure, it was a constraint issue basically rather than
47 anything -- the constraint issue was the major issue there.

48 **MR HEAPS:** Well, the constraint was -- you can assume the
49 constraint was either caused by transmission or it was a lack
50 of local generation.

- 1 **CHAIR:** I think it was transmission but nevertheless --
- 2 **MR HEAPS:** It was actually the breakdown of a local generator in
3 the Bay of Plenty and the lack of availability of water to the
4 local generation in that area that did create a constraint.
5 But the --
- 6 **MS REBSTOCK:** That suggests market power or --
- 7 **MR HEAPS:** That period it does because there was only one
8 generator could then offer the hedge price.
- 9 **MS REBSTOCK:** Sure I understand for that period. How long was
10 that period?
- 11 **MR HEAPS:** I think that period's been going on for quite some
12 time.
- 13 **MR THOMSON:** Six months.
- 14 **MR HEAPS:** Yeah, about a six month period.
- 15 **DR CRAUFORD:** Another example, we're going to get on to FTRs in a
16 few moments. But the major concern that the industry has with
17 the FTR design is that it does not deal with market power
18 issues. Now this is an issue that has been raised by the
19 generators and retailers of being of real concern to them,
20 even if there is a market power in a particular region only
21 for a few hours, they're concerned that this costs them large
22 amounts of money. So, they are saying to us in relation to
23 the FTR design that market power is a problem.
- 24 **MR THOMSON:** It's a marginal priced market working which works on
25 the top volume. Now, when you get for instance in Auckland in
26 the high load periods you get constraints coming in and you
27 then get -- you've only got three generators there, one of
28 whom is run of the river. He's still very big but he's run of
29 the river and all the literature I've read overseas on
30 designing electricity markets, three is just not adequate. At
31 the top periods you're get market power. Facts of life. I
32 don't think it's economic to put transmission in for it. I
33 haven't done the analysis, but it sticks out. It's that sort
34 of market.
- 35 I'm sorry, but there definitely are market power issues
36 for considerable periods of time, like a month or two months,
37 and that will at least -- it won't get any better. When
38 you've got a shortage of water in the South Island, you've got
39 a market power issue. Can't get enough south. I'm sorry, but
40 the market is quite volatile in high load periods and there is
41 high prices. I'm not saying there's anything wrong with it,
42 but just realise they're dominant positions where a generator
43 can make very good money. He should. If I was running it I
44 would be.
- 45 **MR HEAPS:** I think it's important as well to realise that whilst
46 there might be transient conditions, the fact that they can
47 occur makes it difficult for other retailers to go in and
48 offer fixed prices.
- 49 **MS REBSTOCK:** I guess I would like to know when a transient
50 position of market power becomes market power for our

1 purposes. I would invite you to come back to us in a more
2 specific way. Because it is an important issue for us in
3 terms of starting point of our analysis here on the
4 competition effects.

5 **CHAIR:** I could just add if you do come back to us, if you could
6 make it as soon as you can because we want the applicant and
7 others to see a copy of initial submissions so they can have a
8 chance to look at it.

9 Just one further question, the Market Surveillance
10 Committee report which you've got in your footnote and I think
11 it was amended to your main submission, it talks about
12 possible oligopoly. Do you think if it hadn't been for the
13 climatic conditions last year that same comment would have
14 been made, if it was a situation where field supplies, namely
15 water, would have been normal, what would your view be in that
16 situation?

17 **MR THOMSON:** I alluded to it when I opened up. The loads are
18 coming up in the country. Say they're growing at two and a
19 half percent a year, they hydro storage is staying constant
20 and it's 60% of your loading, it becomes more fragile as the
21 loads come up, and the gas supply, it is not getting any
22 bigger, it's probably diminishing, certainly the rate of draw-
23 off you can get is diminishing.

24 So, over a period, you know, you're looking over a five,
25 seven year period or something like that, you're definitely
26 going to find more tight periods on the electricity system. I
27 don't know what Kevin, Bill, Pete --

28 **CHAIR:** If you leave the climate out of it, nevertheless you'll
29 still get those tight periods because of the structural change
30 you're saying?

31 **MR THOMSON:** That's where we are.

32 **CHAIR:** That's your point, okay thank you.

33 **MS CALLINAN:** If I could just resume. We were talking about
34 failure to develop pro-competitive rules and just making some
35 general points. The point that I'd made in B was that the
36 applicant had conceded that there were risks with the supply
37 side misuse of market power, but relies on sanctions built
38 into the arrangement to reduce that risk and specifically
39 transparency and review under the Act, and Transpower's
40 submission is that those checks are not going to be
41 sufficient. I think probably we've covered that in quite a
42 lot of detail already so I'll just make that point and move
43 on.

44 The market power enjoyed by the generators explains to a
45 large degree the failure of the industry to introduce features
46 aiding demand side participation and disclosure of bid offers
47 and Nicki Crauford will talk to the first of these in a
48 moment.

49 The Cobb TransAlta case is an example of a virtually
50 integrated generator not acting in the interests of its retail

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1 arm. It might be useful just to explain that example. Cobb
2 is an electricity generator owned by TransAlta located at the
3 top of the South Island and as such it was charged
4 Transpower's HVDC charge which is a charge associated with the
5 link between the North and the South Island.

6 Cobb disputed that it had to pay that charge with
7 Transpower. The point of that is if Cobb was right and South
8 Island generators didn't pay that charge then in fact the
9 charge would be moved to North Island load customers. So
10 TransAlta, wearing its retailer hat, would have had to pay the
11 HVDC charge.

12 So, the question is why would a generator retailer have
13 sought to shift the burden on to the retail arm? The answer
14 is because retailers are all homogeneous. At the end of the
15 day if the charge is moved on to a retailer, any retailer
16 charging, or trading through a particular lines company will
17 see the charge equally. The reason we give that example is
18 because although the generator/retailers wear two hats, it's
19 often going to be the generator side of the business that
20 drives what the company is doing. That's just one example of
21 that.

22 The other reason why, another reason why we say in E
23 there Cobb a failure to develop pro-competitive rules, is new
24 entrants who are not yet members to the Rulebook do not have
25 voting rights and consumers have limited voting rights under
26 the arrangement so their influence is going to be limited.

27 Point F, while rules may not be struck down per se, as
28 Alex Sundakov's already said there may be more subtle ways to
29 block pro-competitive rules. They may not be introduced, they
30 may not be prioritised, or they may be delayed by the relevant
31 working group and we're going to get to some examples of that
32 soon.

33 This is a point that Peter's just made where New Zealand
34 initially led the world in market design, the market has in
35 Transpower's view failed to live up to its promise.
36 Specifically the evidence is that the industry has not
37 promulgated pro-competitive rule changes to the extent one
38 would have expected in a pro-competitive market.

39 **MR CURTIN:** Could I just ask a question for information there?
40 You've footnoted Professor Hogan's discussion of the PJM
41 market there as an example of a market that perhaps has moved
42 on or ahead of us in design. Do you have a certain view on
43 whether you think the PJM design is a useful one to look at
44 for New Zealand's purposes?

45 **MS CALLINAN:** This leads very nicely into me handing over the
46 next section to Nicki Crauford because that was the first
47 issue she was going to address.

48 **MS REBSTOCK:** Just before you go on to the next section. On F my
49 understanding is in the proposed arrangement the EGB industry
50 board would set the priorities for what rules would be

1 considered and in what order. I think the applicant made the
2 point that the board itself does have the ability to set the
3 priorities for the working groups.

4 **MS CALLINAN:** That may be correct. I'll need to check that and
5 come back to you.

6 **MS BATES:** Just to clarify Professor Hogan's position, it didn't
7 seem to me that he was saying that there was anything
8 particularly wrong with market design as it is now. He was
9 much more concerned about governance issues than design
10 issues.

11 **DR CRAUFORD:** He's also concerned that some significant market
12 improvements have not happened in this country. We made a
13 good start in 1996 but that things haven't moved forward. I
14 think the particular example that he mentioned was FTRs.

15 **CHAIR:** I think we might taken 10 minutes now and come back at 5
16 past sharp and Dr Crauford can pick up on the pro-competitive
17 rules, so we'll break until 5 past 3.

18

19

Adjournment from 2.55 pm to 3.05 pm

20

21 **CHAIR:** We'll reconvene as 5 past 3 has now arrived. Can I just
22 look briefly at the timetable before we get back to the
23 substance. I would like if possible to finish at 4.25 sharp
24 and then start again in the morning at 12. If Transpower
25 hasn't finished by 2.30 we'll probably ask CC 93 to see if
26 Transpower can come on again after today and then there is
27 still time towards the end of the week if we get caught up
28 there.

29

30 The important thing is to give the applicant time to be
31 able to prepare a response to everything that's gone on. Bill
32 Naik is doing some talking behind the scenes, so we'll
33 reconvene, 4.25 we'll finish today exactly and start again
tomorrow sharp at 12. So, Miss Callinan please.

34

35 **MS CALLINAN:** Just one point following on from the discussion
36 that we had before the break. Peter Robertson's just going to
37 address this issue of the board being able to price rise the
rule-making.

38

39 **MR ROBERTSON:** And I think it's by way of acknowledgment that the
40 language on page 15 item F was possibly a bit loose. Indeed
41 in the rules as you point out the board does have the ability
42 to prioritise, indeed they even have the ability to introduce
a proposed rule.

43

44 I guess our point at item F ran to the practical reality
45 of what they can do having introduced a rule and recommended
46 the priority -- they really are in the hands of the working
47 group and they can only put a rule to vote when they receive a
48 positive recommendation from the working group. They can
49 change the working group. They can resubmit it to the newly
50 constituted working group, but they don't -- you know they're
back in that realm of exhortation and we have some material

1 that Nicki will talk to later on that talks to the extent to
2 which rules have been bound up in the process of
3 consideration.

4 So, the blockage doesn't really happen at the time of a
5 vote, it happens in the process of considering.

6 **CHAIR:** I might come back and ask a few questions when Dr
7 Crauford gets to that. Dr Crauford carry on please.

8 **DR CRAUFORD:** We are going to talk about PJM and the comparison
9 with the New Zealand market, and this refers to a question
10 that was raised earlier. We think that PJM is a good
11 comparison with New Zealand. There are many differences, such
12 as its interconnected nature with other systems and so forth.

13 But there are also some huge similarities. In
14 particular the fact that it uses nodal pricing, the same
15 method of pricing for energy and deals with constraints in the
16 same way. That creates a very large similarity with the way
17 in which New Zealand works. So, we think it is a valid
18 comparison.

19 The problem with making comparisons with England and
20 Wales or other places where they calculate the price
21 differently is that you're going to get a very different --
22 it's not going to be a valid comparison. It's much more valid
23 with PJM.

24 The point that Peter raised earlier was that, yes, we
25 have very good rules in this country and Bill Hogan made the
26 point that it's world leading, but that very little has
27 happened to the market rules since 1996. There have been no
28 major changes to the market design. That would be very
29 unusual.

30 By way of comparison, in PJM they did not introduce
31 nodal pricing until 1998. In 1997 they introduced a zonal
32 pricing, which failed within a few weeks and they had to
33 withdraw the entire market and so they got nodal pricing up
34 and running in 1998.

35 Since then they have introduced one major change to that
36 market every year. In 1999 they introduced financial
37 transmission rights. In 2000 they introduced a day ahead
38 market and since then, since 2000 they have introduced other
39 expansions which are more related to expansion into the
40 midwest, for example, and other things to do with the things
41 that are much more relevant to them rather than a good
42 comparison with New Zealand.

43 So, the point we would like to make here is that there
44 really has been no major changes in that time in New Zealand
45 by comparison to PJM where there have been a one major change
46 each year.

47 I'd then like to go on and talk about FTRs. First of
48 all to explain what FTRs are. They are a financial hedge that
49 helps protect energy purchasers or generators from price
50 uncertainty caused by transmission loss and constraints. The

1 important point here is that FTRs are funded by rentals. You
2 can come up with a financial instrument that is not funded by
3 rentals, but it is not an FTR and you will find that there
4 have been no financial instruments that have developed in the
5 market since 1996, mainly because managing losses and
6 constraints is a very risky business.

7 The point about FTRs is that rentals provide a natural
8 hedge to transmission losses and constraints and therefore
9 they should be used as that hedge and offered through an
10 auction process. The proceeds are then returned to the
11 parties who pay for the sunk costs of the grid in the same way
12 that we currently use the rentals.

13 FTRs have had a fairly checkered history. They have
14 been spoken about and thought about in New Zealand since the
15 early 90s and yet they have still not been developed. They
16 are important because they facilitate both retail competition
17 by providing price certainty, but also they assist merchant
18 new investment by solving some of the free rider problems.
19 This was a subject that Bill Hogan spoke about and is I
20 believe the main reason that he feels that FTRs are the
21 natural next logical development in the New Zealand market.

22 **MS BATES:** So you don't get them with the PJM system?

23 **DR CRAUFORD:** Yes, you do.

24 **MS BATES:** Sorry I must have missed that, did you say that did
25 you?

26 **DR CRAUFORD:** Yes, I think I did.

27 **CHAIR:** If this solves the free riders problem, then there must
28 be incentives on generators to subscribe to a system of rights
29 like these, surely?

30 **DR CRAUFORD:** Yes, you would think so. I think some of the
31 reasons that the generators and retailers don't like them are
32 concerned with the issue of market power. The main reason
33 that the generators are giving us that they don't like FTRs is
34 market power. It is the only significant design issue that
35 they have raised.

36 I think one of the issues that we would like to raise
37 here is that FTRs don't create market power. The issue here
38 is that they potentially make, if there is existing market
39 power in the energy market, FTRs can potentially increase the
40 stakes.

41 So, a generator if they also purchase an FTR into an
42 area where they have market power, then they can make money
43 both out of the energy market and out of the FTR market. FTRs
44 don't create market power if it doesn't exist at the moment.
45 That's the major concern that the generators have.

46 One of the issues that we would raise would be, well,
47 you don't solve market power in the FTR market. You don't
48 create a design of FTR that is effectively watered down, so
49 that you can't use it in areas where there is market power.
50 What you do is you try to address market power in the energy

1 market. There are several examples throughout the world where
2 there is a market power mitigation scheme in operation.
3 Alberta is one example, PJM, New York, they all have systems
4 whereby the system operator will ask a generator to modify its
5 bid if it identifies that there is a localised transitory
6 market power problem.

7 **MS REBSTOCK:** How does it do that?

8 **DR CRAUFORD:** They would analyse the conditions in a particular
9 area so there would be -- they would identify a particular
10 area as having transitory market power and when the particular
11 conditions arise that lead to that happening they would ask
12 the generator to potentially reduce their offer, so they get
13 paid a reduced amount. They can't exploit their market power
14 position.

15 **MS REBSTOCK:** So they direct them to change their bid or they ask
16 them?

17 **DR CRAUFORD:** They direct them. Largely that would happen in an
18 area where there is a transmission constraint into an area.
19 So, if a constraint's binding, that generator would be asked
20 to change its bid.

21 **MR THOMSON:** In some other jurisdictions like Australia,
22 Queensland, the local operator is allowed to own peaking plant
23 and actually buys a gas turbine to keep the price down.
24 That's what they've done in Christchurch and Queensland. The
25 PJM model is a lot better, because you get interference in the
26 market from a neutral party if you don't do what Nicki said.

27 **DR CRAUFORD:** Just going back to some of the history of FTRs. As
28 I said, they have been spoken about in New Zealand since the
29 early 90s. They were not introduced in 1996 largely due to a
30 lack of time. A number of working groups -- as we discussed
31 under loss and constraint rentals -- a number of working
32 groups have been brought together largely under the NZEM to
33 talk about loss of constraint rentals and there have been a
34 number of rule change proposals to change the current
35 allocation. At least two of those working groups have
36 considered FTRs specifically and not reached a consensus on
37 it. In the absence of --

38 **MS REBSTOCK:** Can you just explain to me, in what way is it
39 possible for some industry participants to exploit market
40 power through FTRs?

41 **DR CRAUFORD:** In the same way that they can through the energy
42 market. If, for example, there is a constraint into a region
43 so that there is then one generator, one marginal generator in
44 that area, effectively in the energy market they set the price
45 in that area. If they have also purchased an FTR into that
46 area, then they will get the rentals associated with the
47 difference in price between what that marginal generator is
48 setting and the other side of the constraint.

49 So, in that way there is two ways in which that
50 generator can exploit its market power. One through the

1 energy market, and also by purchasing the FTR, and getting the
2 rentals back. And its setting the value of the rentals on
3 that line.

4 **MS REBSTOCK:** In the absence of something that deals with the
5 absence of market power, do you think it's unreasonable for
6 the players to expect Transpower in introducing a product like
7 this to take no account of the ability to exercise market
8 power in a new way?

9 **DR CRAUFORD:** I think there are two issues. One is this issue of
10 market power is one that's raised by the generators as being a
11 complete show stopper for FTRs. We don't know that that's
12 true. We don't know how much of a problem it is. There are
13 other ways of mitigating it in the FTR market. For example
14 information disclosure.

15 In the energy market there is no limit on the amount of
16 money that people can make into a constrained area. The limit
17 effectively is set through information disclosure, the fact
18 that it is publicly known that they are exploiting that market
19 power position. The same could be said for the FTR market.
20 It will be known who owns an FTR into that particular region.
21 So, there are ways in which it could be mitigated.

22 I think the issue for us is two points really. First of
23 all, that if market power is a problem and the generators are
24 saying that it is, then it should be dealt with in the energy
25 market, not in the FTR market.

26 The second point is that our view would be it would be a
27 good idea to introduce FTRs on a trial basis, make them short-
28 term, so that we can assess how much of a problem this is. We
29 don't know how much of a problem it is. Does that answer your
30 question?

31 **MS REBSTOCK:** Yeah, it does answer my question. But it's an
32 interesting position to be in to say that the introduction of
33 these FTRs may give rise to additional market power and that
34 you're willing to give it a try and see how it goes, and you
35 think that there's enough transparency that if there's a
36 problem it will be visible and it can be fixed after the fact
37 which seems in direct contrast to your views about the
38 Rulebook.

39 **DR CRAUFORD:** I'd like to make a couple of points there. First
40 of all FTRs don't create market power.

41 **MS REBSTOCK:** No, I understand they don't create market power.
42 But given there is market power they give rise to additional
43 ability to use it, is that right?

44 **DR CRAUFORD:** The second point is the order of magnitude of what
45 we're talking about here. The energy market, rentals are only
46 ever going to be something like 10 % of the value of the
47 energy market. If people are exploiting market power and it's
48 not been raised as an issue in the energy market by the
49 generators themselves, they have control over the rules in the
50 energy market, they could have proposed a rule change that

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1 will deal with this. There are plenty of examples world wide.

2 They're saying that it's not a problem in the energy
3 market, they don't see the need to do something about it and
4 even though the value in the FTR market is considerably
5 reduced, it's only going to be something like one 10th the
6 value, that it is such a problem in the FTR market that it is
7 a stumbling block; it is that logic that I don't accept. I
8 think if market power is a problem we must deal with it in the
9 energy market. That's not the position that has been taken by
10 the generators.

11 **MS REBSTOCK:** I just want to make sure I understand you. You're
12 basically saying this issue has an exact mirror form?

13 **DR CRAUFORD:** Yes.

14 **MS REBSTOCK:** It's inconsistent to argue it's a problem to argue
15 in this case if it's not generally a problem?

16 **DR CRAUFORD:** Yes. That would be my view.

17 Where I had got to was that a number of working groups
18 had discussed FTRs, but in the absence of any progress on this
19 issue what Transpower has done is it has come up with a
20 preliminary design for FTRs based on what's happened in PJM,
21 given that we currently received the transmission rentals.
22 The introduction of FTRs as I said has been spoken about for a
23 long time. It was first signaled by Transpower in December
24 1998.

25 FTRs are intimately linked with the pricing methodology
26 for recovery of sunk costs with nodal pricing and with new
27 investment. When we rolled out the new pricing methodology to
28 be introduced in 1 April 1999 we mentioned that we wanted also
29 to introduce FTRs. It was a while though before we got going
30 on this. In May 2001 Transpower began an extensive
31 consultation on the preliminary FTR design.

32 One of the criticisms of Transpower that we have heard
33 on many occasions is that the consultation process for FTRs
34 was not adequate. I do not accept this at all. We went
35 through an extensive consultation process with a preliminary
36 design. Following that we also then changed the design quite
37 extensively. We set up an FTR industry consultation group in
38 2001 and it was chaired by an independent chair, Lincoln Gould
39 and we discussed the preliminary design that Transpower came
40 up with and there were representatives of 12 companies there,
41 lines companies, generators, retailers, and major consumers as
42 well. One of the reasons that we didn't do this through the
43 NZEM process was that we wanted a much wider industry
44 representation than simply the generators and retailers.

45 After that consultation round we set up a second
46 consultation round with specifically with the CEO's of the
47 major generators and retailers because they had some
48 particular concerns. It was at this time that the issue of
49 market power that came to the fore. That again was chaired by
50 Lincoln Gould. Officials also attended those sessions.

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1 **MS REBSTOCK:** Can I just ask you a question. Is it completely
2 over to Transpower how and when to introduce these FTRs? Do
3 you have unilateral decision rights in terms of progressing
4 this?

5 **DR CRAUFORD:** We have never considered that we do have unilateral
6 decision rights in this regard, which was why we went through
7 an extensive industry consultation process. This was not
8 something -- we felt that FTRs needed to be introduced into
9 the New Zealand market. We feel that they will help retail
10 competition. There are instances where FTRs will actually
11 breakdown market power as well as other instances where it
12 might create it.

13 We also feel that they can make a major contribution to
14 the problem that we've heard many times of the free rider
15 problem causing a problem with new investment. We felt that
16 it was important to introduce them. We didn't feel as though
17 we had a unilateral right to do that. But we didn't feel that
18 there was an adequate governance process set up within the
19 industry to deal with the issue. Transpower received the
20 rentals, we had the rentals and one of the conditions on which
21 we were given the rentals in 1996 was that we did develop such
22 a product. So, we felt as though it was appropriate to try to
23 facilitate the process of them being introduced.

24 We felt that input from the industry was important. We
25 felt that it was important that we managed to persuade the
26 industry that this was a good product.

27 **MR THOMSON:** Could I just add something to what Nicki said. At
28 the height of the tension the NZEM had rule changes in front
29 of a working group withdrawing the rentals from Transpower so
30 the product went dead. There were injunctions everywhere and
31 it was all on for a while.

32 **MS REBSTOCK:** In order to stop Transpower from introducing FTRs.

33 **MR THOMSON:** I just wanted to add that because that explains some
34 questions you're asking.

35 **MS REBSTOCK:** I'm still not clear, you did have the ability if
36 you chose to simply introduce the FTRs.

37 **MR THOMSON:** No, because they passed rules in the NZEM and the
38 working group to take the rentals away and the product went
39 dead. You can't do it.

40 **DR CRAUFORD:** Can I just clarify that Bob. The moment Transpower
41 receives the rentals, we have done since 1996 and as I say, we
42 have to comply with certain conditions in order that we get
43 the rentals, we have to deal with them in an economically
44 efficient manner. It is true, though, that in order to
45 prevent Transpower from offering FTRs there have been a number
46 of rule change proposals initially aimed at taking rentals
47 away from Transpower totally, stopping Transpower from
48 receiving the rentals. That was withdrawn in earlier this
49 year.

50 There was then a second rule change proposal which is

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1 still pending, which is aimed at stopping Transpower from
2 offering FTRs.

3 **MS REBSTOCK:** What's the source of these rule change proposals?
4 Who was the source?

5 **DR CRAUFORD:** Might River Power and Trust Power.

6 **MS REBSTOCK:** In both cases?

7 **DR CRAUFORD:** In both cases I think. Yes, thank you, Toby.

8 **CHAIR:** I think, move on please.

9 **DR CRAUFORD:** In the midst of this, as part of the winter review,
10 Transpower was asked to put FTRs in by the Minister. This is
11 part of the system whereby we report to the Minister on
12 progress on initiatives that we are charged with doing
13 directly by the Minister that Bob spoke about; we report once
14 every two months. We were asked by the Minister to put FTRs
15 in prior to winter 2002. However, in parallel with this the
16 generators have expressed their concerns with FTRs directly to
17 the Minister of Energy, and in April this year the Minister of
18 Energy determined that he would undertake a review of FTRs
19 using an independent expert. He asked MED to appoint an
20 independent expert, and that was Dr Grant Reid. Dr Grant Reid
21 then produced a report which was certainly very much in favour
22 of an FTR product, and indeed endorsed Transpower's approach,
23 but also suggested some improvements which he felt would also
24 deal with some of the concerns that the industry had raised
25 regarding market power.

26 The final outcome of that review is still pending. What
27 has happened is that a Draft Government Policy Statement has
28 been issued by MED. That suggested basically implementing the
29 solution that Grant Reid proposed, and Transpower has no
30 problems with that. We would be perfectly happy to implement
31 what he suggested. In our view it endorses what we did but
32 goes a stage further.

33 The first draft review was then circulated for
34 consultation with the industry, and there has now been a
35 second Draft Government Policy Statement, which is very
36 different from the first one, particularly in relation to
37 governance, and indeed also in relation to the design of FTRs.
38 It has changed quite substantially. I think that this
39 reflects the problems with Government intervention, is at this
40 stage a long way down the track of trying to determine the
41 design and the correct solution for this product.

42 **CHAIR:** Although, just to interrupt, it's not uncommon for
43 governments to leave intervention until the protagonists have
44 had a pretty good go at working it out.

45 **DR CRAUFORD:** That's true, but I suppose one would expect,
46 particularly under a Crown EGB, that officials and the
47 Government would be pretty much up to speed with the issues.
48 Financial transmission rights are a complex product. We have
49 plenty of people internally within Transpower, and indeed even
50 the most informed of the industry have problems understanding

1 some of the complexities of it. I think that the officials
2 have experienced a steep learning curve in trying to then come
3 up with what is the answer; we've got these people who have
4 very different points of view, how do we come up with an
5 answer that is sensible?

6 **CHAIR:** I mean, from the point of view of this authorisation,
7 you're putting up FTRs as an example of how lack of consensus
8 can delay an issue. We don't need to understand the ins and
9 outs of FTRs per se, one assumes?

10 **DR CRAUFORD:** No.

11 **CHAIR:** Thank you for that.

12 **MR CURTIN:** Just rather as a follow-up, I just wonder if I could
13 understand what you're saying here. I hear what you're
14 saying, I've got the gist of it. We're talking here about our
15 Draft Determination and its thoughts on opposition to
16 developing pro-competitive rules. In thinking back over the
17 rule changes and the various attempts to block or change the
18 introduction of FTRs, I suppose two things conceivably might
19 be going on: One is that currently rentals are allocated one
20 way, they might be allocated another way, and I'll argue as
21 hard as I can to get a bigger share when the music stops. Or,
22 it could be resistance, and that's understandable, I think
23 we'd all do that. But you could also, I suppose, be opposed
24 to them because they had the potential to dilute your existing
25 degree of market power.

26 **DR CRAUFORD:** Yes.

27 **MR CURTIN:** I appreciate where you're coming from, but if you were
28 looking at those two alternative explanations, which is, are
29 they both working, is one bigger than the other, what's your
30 take on the whole episode?

31 **DR CRAUFORD:** I think they're both working. The same argument
32 regarding who gets the rentals you can have with who gets the
33 auction proceeds, because Transpower's not going to be making
34 any money out of this. So, exactly the same arguments work
35 with auction proceeds as well as with rentals.

36 So, you can have an FTR product but then distribute the
37 auction proceeds in a way that is inefficient. I think that
38 there is also quite a lot of genuine resistance to perhaps a
39 complex product; we've managed for several years without it,
40 why do we need this now? We don't need an additional level of
41 complexity in the industry. That is certainly an argument
42 that you get from some consumers who genuinely don't want
43 additional complexity in the industry.

44 I think there is a contingent which says, well, we're
45 managing our risk -- certainly the generators and retailers --
46 managing our risk through vertical integration. The way in
47 which we are currently managing our risk will be broken down
48 and it will lead potentially to a more competitive retail
49 market, and there is resistance to that. So, I think there
50 are a number of things going on there.

1 **CHAIR:** So your view is, it's not the complexity they're fighting
2 against, it's the out that they're against?

3 **DR CRAUFORD:** Particularly the generators and retailers, yes. I
4 think for some of the consumers the complexity of it is a
5 concern to them. But then, the complexity of the wholesale
6 market per se is a concern to them, not just FTRs.

7 **MS BATES:** Let's just go back to the FTRs for a moment, and you
8 said that MED had proposed a solution which Transpower agreed
9 with, right? Then you said there was some consultation with
10 the industry and that what happened as a result of
11 consultation with the industry was, you said, a draft policy
12 which was very different.

13 **DR CRAUFORD:** Yes.

14 **MS BATES:** Can you just tell me what the essential differences
15 were?

16 **DR CRAUFORD:** There were some differences in design, and some of
17 those have been worked through right now, and we're trying to
18 understand whether they were intentional or not. There were
19 also some large differences in relation to governance and to
20 the programme moving forward.

21 In the original Draft Government Policy Statement there
22 was a suggestion of an immediate introduction of a -- of
23 basically the product that Transpower has been suggested with
24 a longer term introduction of some of the more complex -- the
25 greater complexity that Grant Reid is suggesting, and that
26 that would be done through consultation with the industry.
27 The latest Government policy statement is suggesting that
28 nothing is introduced until the industry agrees with the
29 design.

30 **MS BATES:** So, do you feel that -- well, Transpower doesn't agree
31 with the second policy, that's pretty obvious, isn't it, it
32 would prefer the first one?

33 **DR CRAUFORD:** Yes.

34 **MS BATES:** It seems that MED has had the ear of the industry and
35 has made these changes.

36 **DR CRAUFORD:** One would assume that, yes.

37 **MS BATES:** Right, let's take you to the counterfactual because I
38 want to examine whether that's a possible scenario here,
39 because the EGB itself will consult, has to consult, with the
40 industry and there's no guarantee it wouldn't come out with a
41 very similar decision to what the MED has.

42 **DR CRAUFORD:** I think that's absolutely right. There's no
43 guarantee that they won't. I think though that the hope would
44 be that, under a Crown EGB, that the Government and officials
45 would be involved in the process rather earlier, and they
46 would understand some of the complex issues rather better. I
47 have a concern that FTRs should have been introduced into the
48 market back in 1996.

49 So, we have been debating this for at least 10 years, 12
50 years probably, and so it's taking a very long time, and to

1 simply suggest, "well, let's have another round of
2 consultation" is perhaps not a good idea. And one would hope
3 that -- and I see the official's dilemma right now -- they
4 don't know the correct answer. One would hope, under the
5 Crown EGB, that there would be a much more direct involvement
6 and a greater understanding in some of these complex issues.

7 **MS BATES:** Do you see the officials actually being involved at
8 policy formation level with the Crown EGB --

9 **DR CRAUFORD:** Possibly.

10 **MS BATES:** -- sitting with them?

11 **DR CRAUFORD:** Certainly with some of the industry groups we have
12 on FTRs they have been sitting in.

13 **MS BATES:** To take you back to the PJM, there was an introduction
14 of these same things; did that go more speedily, did the same
15 problems occur? If they didn't, what was the difference?

16 **DR CRAUFORD:** No, the same problems did not occur. The system
17 that they have there is that -- well, they introduced nodal
18 pricing in 1998 and then FTRs were introduced in 1999. They
19 have a system there of industry working groups who then would
20 make a recommendation up to the PJM board. That was the
21 process that occurred then and a recommendation was made up to
22 the PJM board and the PJM board would then move ahead with the
23 product.

24 **MS BATES:** But the difference seems to be that the working groups
25 were able to reach consensus there, where they haven't been
26 here.

27 **DR CRAUFORD:** Yes, that's certainly an issue; they have managed
28 to reach consensus there when they haven't here.

29 **MS BATES:** Any reason as to why that might be?

30 **DR CRAUFORD:** I think the system operator has considerably more
31 influence in that process. I think, rather than talking about
32 PJM in this particular example, what has now happened in the
33 US is that FERC, the regulator, has now come up with a
34 standard market design and in that standard market design
35 things such as FTRs are in there. So, there is, therefore, an
36 endorsement at the highest regulatory level for that product
37 to go ahead.

38 **MS BATES:** So you're going to have them, but working groups are
39 going to be -- the focus what they're doing is more limited
40 perhaps because some key decisions are already in place.
41 Could that be the case?

42 **DR CRAUFORD:** I think that's right, yeah.

43 **MR ROBERTSON:** We can imply from that that necessary pre-
44 determination on the part of the PJM board, but the fact that
45 the PJM board had the decision-making role on the
46 implementation of these things, I think we would argue, makes
47 a difference to the focus of the working groups.

48 **DR CRAUFORD:** I think that's a key point, yeah.

49 **MR THOMSON:** That's the difference between an industry EGB and a
50 Government EGB, because one's got the decision-making and the

1 other hasn't. Sorry but...

2 **MS BATES:** No need to apologise.

3 **MR THOMSON:** They all tell me off.

4 **MR CURTIN:** Just before we move on from FTRs, is there any sense
5 in which the FTRs Cobb regarded as a substitute for physical
6 investment in the grid?

7 **DR CRAUFORD:** No.

8 **MR CURTIN:** Why not?

9 **DR CRAUFORD:** They don't give a physical property right, they
10 give a financial property right. So, if somebody makes an
11 investment in the grid, one of the major concerns is that it's
12 an interconnected system and anybody can use that increasing
13 capacity, for example. What FTRs do is, they provide a
14 physical property right -- sorry, a financial property right
15 for that increase in capacity on the grid. But it is not a
16 physical right; it's simply a financial one.

17 **MR CURTIN:** I appreciate that. I suppose I was thinking --
18 supposing I was a potential purchaser in, I don't know -- Bay
19 of Plenty to take an example, and I come along and say, oh,
20 there's a constraint along the way, Transpower have put in
21 next to a line a bigger line or whatever you do. Are you
22 likely to come back and say, well, if you've got such a big
23 problem, why don't you just buy FTRs instead?

24 **DR CRAUFORD:** That's true, they are a hedge product so they will
25 provide price certainty if there is a constraint, if you
26 purchase an FTR and there is then a constraint then you, as a
27 consumer, have managed to hedge your risk. But they don't
28 provide a substitute for a physical increase in capacity.

29 **MR CURTIN:** I understand that.

30 **CHAIR:** They're a way of rationing existing capacity.

31 **MR ROBERTSON:** I think in cases not obvious as well, that the
32 process of acquiring the financial transmission right involves
33 the purchaser in making an estimate of the likely value of the
34 instrument over its life, so they're not costless. You pay
35 what you think the constraint value will be and you win if the
36 constraints are greater or valued higher, or you might lose as
37 well. So, in that respect it's not dissimilar to taking
38 foreign exchange cover.

39 **CHAIR:** It's a hedge under another name, isn't it?

40 **MR ROBERTSON:** Yes.

41 **DR CRAUFORD:** I think, just to finish off on FTRs, I think our
42 concern would be, under the EGB, the issue of transmission
43 rentals, as we discussed earlier, is dealt with under Part F
44 and the generators and retailers have a vast majority of the
45 votes under that, and I would question whether the
46 introduction of FTRs is going to be possible at all under the
47 EGB unless the generators and retailers agree to it.

48 **CHAIR:** That's your point; leaving aside the nature of the
49 product, that's the point you're making?

50 **MS REBSTOCK:** Does the FTRs diminish the incentive to invest to

1 remove the constraints in the first place?

2 **DR CRAUFORD:** If you are the holder of an FTR then you might be -
 3 - then you might be -- you have a hedge against the price
 4 uncertainty, and provided there is sufficient physical
 5 capacity, provided you're not simply into a particular region,
 6 i.e. You're just paying a higher price for a higher charging
 7 generator rather than there actually being a physical -- a
 8 total capacity constraint, then they might do. But if there
 9 is competition, then other parties in the market would be
 10 incentivised to actually remove that constraint in order to
 11 reduce the value of the constraint.

12 **MS REBSTOCK:** What is the suggestion we'd be in? I mean, I'm just
 13 trying to understand whether these FTRs in any way actually
 14 provide a short-term solution but actually heighten an
 15 investment problem in terms of the constraints.

16 **DR CRAUFORD:** They're auctioned continuously. At the moment
 17 we're hoping to introduce a short-term product again, just to
 18 see how it goes, of one month, so they would be auctioned each
 19 month, and so, you have no guarantee of actually getting that
 20 FTR. There is an open auction; other people could potentially
 21 purchase it. So, it's going to provide some price certainty,
 22 but not any long-term price certainty. So, all they're doing
 23 is highlighting to the market the value of the constraint over
 24 that FTR period, so they're not going to prevent new
 25 investment from occurring. What they could substantially do
 26 is to suggest to the market when it becomes economic for that
 27 new investment to occur, because there is some indication as
 28 to the value of that new investment.

29 **CHAIR:** Let's continue please.

30 **MS CALLINAN:** I'd just like to continue again at paragraph 2.8.
 31 The applicant has put in a fairly detailed analysis of various
 32 NZEM Rule changes and provided a summary of those rules, and
 33 that summary is to support the thesis that, despite the
 34 acknowledged risk of misuse of power by the supply side, the
 35 record in fact shows that any potential misuse already extant
 36 under NZEM has not been exercised. Transpower wants to
 37 address that point by the applicant.

38 Transpower's not suggesting in this section that there
 39 has been misuse of market power. What Transpower's saying is
 40 that the analysis of the NZEM Rules put forward by the
 41 applicant does not demonstrate that there won't be misuse of
 42 market power by reference to what's happened with NZEM as an
 43 example.

44 I'd just like to address a couple of points and then
 45 we'll go on to a graph which, again, Nicki will take you
 46 through. First of all, fundamental point, the record of votes
 47 through the NZEM doesn't address Transpower's point that
 48 blockage or defeat of pro-competitive measures could well
 49 happen before there is a vote.

50 And, just to the third point; any evidence that the

1 industry has done or will do something pro-competitive does
 2 not itself prove the competitive superiority of the proposal
 3 unless it is shown that the Crown EGB would not have done the
 4 same thing or would have taken longer to do it. You've got to
 5 keep bearing in mind, in our submission, the comparison with
 6 the Crown EGB, which is why Nicki Crauford's comments at the
 7 tail end of that discussion on FTRs are so apt; that in
 8 Transpower's submission the delay would not have been so long
 9 had there been the counterfactual in place.

10 But, just to take you to the appendices at the back of
 11 the submission, and to page 24, Transpower has analysed the
 12 NZEM Rule changes that were put forward by LECG, has accepted
 13 LECG's categorisation of those changes into pro-competitive
 14 changes where they exist, and has simply graphically
 15 illustrated them according to how long the change took to go
 16 through or where the delay is. The figures involved are the
 17 pro-competitive rules, and the basic point that's coming out
 18 of the graph is that there is a cluster of pro-competitive
 19 rule changes that have been delayed for a considerably longer
 20 period than the relatively uncontroversial rule changes, but
 21 Nicki, maybe you can just add some comments to that.

22 **DR CRAUFORD:** The point here is that the way in which LECG has
 23 reported on these rule changes is that they have not included
 24 several pro-competitive rule changes that are unresolved and
 25 have been unresolved for between two to five years. That's
 26 the ones shown on the far right here in black on the far right
 27 in the chart. So, there are a number of unresolved pro-
 28 competitive rule changes that have not gone through.

29 **MS REBSTOCK:** What is the significance of these? Can you tell us
 30 what they're about, the unresolved ones?

31 **DR CRAUFORD:** I can give you some. I don't have huge detail, but
 32 some detail. There were 90 rule changes listed, of which 27
 33 are claimed to be pro-competitive. Of those 27 pro-
 34 competitive, 11 of these 27 are unresolved or related to the
 35 release of bid and offer information which, as you know, is
 36 being resolved through the Government intervention.

37 Of the unresolved proposals, of the unresolved
 38 proposals, they include a fundamental review of the present
 39 market design, i.e. Whether nodal pricing should remain or
 40 not. Five of the other pro-competitive rule changes relate in
 41 the text to a single rule change, i.e. The introduction of
 42 must run dispatch auction. Therefore, if you remove the
 43 double counting that we think has occurred here, that leaves
 44 12 pro-competitive rules that have been resolved since 1996.
 45 Some of those would relate to administrative issues and
 46 maintaining consistency with MARIA, for example, they're
 47 listed on the following page.

48 So, there are very few pro-competitive rule changes of
 49 any significance, of any materiality, that have actually gone
 50 through. I'd add to that the ones that are unresolved, which

1 includes the issue of loss and constraint rentals; then we
 2 think that the evidence of the rule change proposal considered
 3 by NZEM does not support the contention that there is not a
 4 systematic bias to delay all prevention of pro-competitive
 5 rule changes.

6 **MR CURTIN:** Just following that up, I don't have the Hansen
 7 Murray paper just to hand, we've been generating paperwork
 8 like anything. But my memory from it was that their argument
 9 was that there was only a small number of pro-competitive
 10 rules knocked back or unresolved and, of that small number,
 11 most of them, they said, were in your court in that you'd
 12 asserted jurisdiction over it or pulled it for one reason or
 13 another. Our job is kind of to bounce this evidence around,
 14 and I was just wondering what your take was on that?

15 **CHAIR:** I think you quote that in the following page; you quote
 16 from Mr Hansen's evidence, which picks up that very point that
 17 he's saying, and I'm not sure whether he's suggesting that
 18 they've been blocked for any other reason than security
 19 reasons.

20 **DR CRAUFORD:** I think that we would disagree that we had -- I
 21 mean, I can go through each of these, but it's probably not
 22 worth it. We would disagree that. Most of these we have not
 23 held up. We do not believe that Transpower has held up for
 24 security reasons or any other reason; for example, real time
 25 pricing, we would disagree with that. The only one where we
 26 think we have opposed the rule change would be the one on loss
 27 and constraint rentals. So, we would disagree with that.

28 **MS REBSTOCK:** That one actually failed right, that vote on the
 29 loss of the rentals?

30 **DR CRAUFORD:** No, there was one that was withdrawn and a second
 31 rule change proposal is still currently pending.

32 **MS CALLINAN:** Just following on from what we were just talking
 33 about. I don't know whether the Commission wants us to
 34 discuss it, but Nicki, I'm not sure if you're already
 35 referring to appendix 6 where, at page 26 of the appendices
 36 where --

37 **DR CRAUFORD:** Yes, we were just talking about that.

38 **MS CALLINAN:** Well, the next issue is really back to Nicki; we
 39 were going to give another example, a more specific example of
 40 where the delays were -- it was suggested that Transpower was
 41 responsible for delays, and Nicki was going to address that in
 42 relation to demand side participation.

43 **DR CRAUFORD:** Yes, in relation to demand side participation --
 44 I'll just go through this briefly because we have probably
 45 covered the point in relation to demand side participation.

46 It's incorrect to say that Transpower has not agreed to
 47 reduce the time for dispatch to below two hours. The issue is
 48 that we are unable to reduce the time below two hours.
 49 However, we do not feel that this is what has blocked demand
 50 side participation. We feel that a more important initiative

1 in relation to getting demand side participation is real time
 2 pricing and, in relation to the two hour rule, our reasons for
 3 not reducing the two hour dispatch time is one of technology.
 4 We need to do the necessary security analysis, before real
 5 time, once bids and offers have been fixed. We also need to
 6 allow time if there are any concerns with security for the
 7 generators, for example, to respond to any requests for
 8 further generation for example. Therefore, it's not possible
 9 for us to reduce that two hour dispatch time any further,
 10 except that we have already reduced it from four hours down to
 11 two hours, so we have made some concession there.

12 But we have also suggested to the NZEM and PWG that we
 13 could reduce it for the demand side but not for the supply
 14 side, and I think that that is a suggestion that has been
 15 rejected by them. We don't know how far we could reduce it at
 16 the moment, but we have suggested that we could look at that
 17 issue.

18 **CHAIR:** What would be a reason for rejecting it?

19 **DR CRAUFORD:** I think the discussion that occurred was that they
 20 are not very keen on there being a different window for the
 21 supply side and the demand side. They think they should be
 22 the same.

23 **MS REBSTOCK:** What happens in other networks? What's the time
 24 that's normally taken?

25 **DR CRAUFORD:** This tends to be less of an issue in cases such as
 26 PJM. Again in PJM, for example, any generator that is
 27 available must offer in, so we don't; there isn't -- there is
 28 far less of a bias in the rules in New Zealand towards
 29 security than there are in other jurisdictions, and this is a
 30 case in point in PJM. The only reason that a generator would
 31 not offer into the market would be if they have an outage, and
 32 their outages must be agreed by the system operator.

33 In this country the generators don't have to notify the
 34 system operator of their outages, and they don't have to have
 35 them agreed by the system operator, whereas they would in PJM.
 36 In PJM, of course they can offer a very high price if they
 37 really are determined that they don't wish to run that
 38 particular time, but they must offer in, and that's not the
 39 case here. Generators can choose not to be available for any
 40 reason that suits them. That does create more of a problem on
 41 security, and it might be another jurisdiction.

42 **MS REBSTOCK:** So, is there no two hour rule in PJM?

43 **DR CRAUFORD:** I would need to check.

44 **MS BATES:** When you're talking about available technology, do you
 45 mean technology available to Transpower at that particular
 46 time, or are you talking in a wider context as there being no
 47 such animal which would enable this to be done?

48 **DR CRAUFORD:** I'm talking in a wider context. One of the
 49 complications in New Zealand -- I don't have an example in
 50 PJM -- is the inclusion of losses in the system. Losses are

Transpower

1 very important in New Zealand because of the long stringy
 2 nature of the design. They don't have losses in the PJM.
 3 They have losses, but they don't have them in the model.

4 So, it makes it, in order of magnitude, quicker, easier
 5 to solve. That would be one example. So, we do have to do
 6 some security analysis where you can't do it any quicker;
 7 there is no technology do that.

8 **CHAIR:** Okay, thank you.

9 **DR CRAUFORD:** Real time pricing. Murray and Hansen have painted
 10 Transpower as responsible for the delays in real time pricing
 11 commencing with the issue that issues raised by Transpower
 12 regarding cost and security has slowed down progress. We
 13 would disagree with this. In fact, we think that the
 14 alternative approach that Transpower has come up with, i.e. Of
 15 an ex-post price rather than an ex-ante one is the reason that
 16 we have managed to reduce the proposed costs down from \$2.4
 17 million down to \$700,000. We did have some major security
 18 problems with the ex-ante option.

19 We have also felt that, if we came up with an ex-post
 20 option, we could come up with something which was a price
 21 indicator rather than a full settlement option and, therefore,
 22 that would make it considerably cheaper.

23 In fact, the delays have been by the generators who were
 24 not prepared to pay for the cost, and there has been a lot of
 25 debate on the cost.

26 **MS REBSTOCK:** Can I just ask you a question. What is the
 27 incentive on Transpower to give weight to things other than
 28 security concerns? There's a strong suggestion all the time
 29 that security is Transpower's concern, there's not enough
 30 balance there. In other words, they maximise security against
 31 very little constraint, and you have the power to do that.
 32 Others might suggest that your concern for security needs to
 33 be balanced a bit with the industry's concern for cost and
 34 other types of efficiency.

35 So, I put this question to you in that context. What is
 36 the incentive on Transpower to try to achieve security at a
 37 minimal cost when the cost sits with other players other than
 38 Transpower?

39 **MR ROBERTSON:** If I could answer that, others may care to chip in
 40 along the way; but presumably your question is directed at the
 41 current regime under which we operate?

42 **MS REBSTOCK:** Yes, the current regime. I want to understand that
 43 before we worry about what might happen in these proposals.

44 **MR ROBERTSON:** I think the Statement of Corporate Intent is the
 45 strongest driver of Transpower's culture. This has become a
 46 cultural issue. The Statement of Corporate Intent really
 47 directs us to look at efficiency and, amongst other things,
 48 either in the Statement of Corporate Intent explicitly or
 49 through the side letters Bob has referred to.

50 We're also reminded that we should seek to satisfy our

1 commercial objectives only after we've made sure we're doing
2 things which are in the national interest. So there's a
3 strong driver on Transpower to do that.

4 **MS REBSTOCK:** But your actual accountability primarily rests
5 around achieving a certain amount of security. That's not
6 your primary --

7 **MR ROBERTSON:** Well, I'm not sure on what basis you say that.

8 **MS REBSTOCK:** I'm asking you.

9 **MR ROBERTSON:** The Statement of Corporate Intent is effectively a
10 contract between our board and the Government, which is
11 renewed every year, and it plays as strong emphasis on
12 national efficiency, efficient outcomes, efficiency in the use
13 of transmission and wider energy resources.

14 As a practical example, if you look -- someone else is
15 going to speak in another context about the issues we wrestle
16 with in terms of the security of supply to let's say, the
17 Auckland region. A simple description of the situation in
18 Auckland is that some time in around about 12 years, 10 years
19 from now we expect Auckland's growth will exceed our ability
20 to preserve an N minus 1 level of security.

21 About two years ago we concluded that we needed to do
22 some upgrades urgently because the protracted discussions that
23 had taken place around seeking to establish a commercial
24 understanding upon which the upgrades might take place had not
25 produced any definitive resolution, so that, we undertook
26 something of the order of \$20m worth of short-term investments
27 so that we could ensure we continued to be in that position of
28 being able to deliver at least N minus 1 security.

29 One of the arguments that we have been running in the
30 course of that discussion has been that, given that there is
31 such a long lead time before our ability is -- to sustain N
32 minus 1 is exceeded, is that we should follow what we would
33 call a "least regrets" approach. Which is to say that, in the
34 ensuing four or five years we should secure the ability to
35 implement a transmission solution for Auckland and that means,
36 for example, negotiating the resource management consents and
37 what have you that, in effect, allowed us to buy the option to
38 roll out the transmission solution, but we've been quite
39 determinedly arguing that we shouldn't simply press automatic
40 pilot and proceed to roll out that transmission solution
41 because, in our view, there may well be cheaper new technology
42 options available within that time window.

43 That, to me, is a very practical -- that's been in the
44 face of lots of assertions from parties who say we should do
45 the opposite; that is, just roll out the transmission
46 solution. The same parties are not quite as willing to step
47 forward when it comes to determining what share they might
48 pay. But our genuine belief is that we should be very mindful
49 of the possibility for technologically superior alternatives
50 to appear within such a long window of time.

1 **MS REBSTOCK:** I guess -- I mean, I take that point but my -- maybe
2 I didn't express it clearly, but the rest of the industry --
3 you could take part of this proposal and part of the genesis
4 of this proposal to be a little bit about redistributing who
5 has a say on overall investment in the electricity industry as
6 a whole.

7 You might want to think about, maybe there's an attempt
8 to think about optimising across the different sectors. My
9 question to you really is, when do you put the overall
10 electricity network across -- beyond transmission, ahead of
11 what might be efficient in the transmission sector of the
12 network? Because, what we hear I think a lot of is that
13 Transpower thinks narrowly about the transmission part of it
14 and optimises within that; irrespective of the cost and
15 benefits in the rest of the network. So, I just want to ask
16 you, what is your incentive to look beyond your own -- the bit
17 that you are accountable for?

18 **MR ROBERTSON:** Perhaps it's me to apologise for not having been
19 clear. I had attempted to use the Auckland example as an
20 example of a situation where we were precisely holding back
21 from rolling out the transmission solution, because we
22 believed that some of the new technologies that might be
23 available within that timeframe would be non-transmission
24 technologies, distributor generation and the like. Indeed I
25 point to a lot of the discussion Nicki has been the centre of
26 in the last hour or two, has been, you might call them
27 technologies, but market design issues, nodal pricing, which
28 are all focused on producing dynamic efficiency in the
29 industry, which is getting the right investment in the right
30 place in the right technology at the right time. That's been
31 the driver in Transpower.

32 **DR CRAUFORD:** And that is covered in the SCI in terms of us being
33 efficient. So, I'm not sure that there is the conflict
34 between wanting an overall efficient market design and
35 necessarily -- we don't see the conflict, shall I say, in
36 pushing the transmission option to the exclusion of others
37 doesn't become a conflict for us. What we see is important is
38 the overall design in sending the correct new investment
39 signals at the right time.

40 **MR ROBERTSON:** If we wanted to look at this -- and we've had this
41 discussion in the past, if we wanted to look at this and say
42 let's take off that national interest hat, because that might
43 seem a bit pompous, and let's put our commercial hat on; we've
44 considered that it's in our long run interests to encourage
45 the optimal investment in technologies, be they demand side
46 alternatives, generation alternatives or transmission
47 alternatives because, if we didn't do that we ran a
48 significant risk of considerable asset write down under the
49 optimised deprivation value approach. That really is another
50 piece of the incentive operation on Transpower.

1 **MR THOMSON:** Can I add something else? You heard the industry
2 say that we concentrate on security, and yet you've also heard
3 the industry say that we're under-investing on transmission.
4 The two do not go together. If you're putting security first,
5 you're going to over-invest in the transmission, because
6 that's the safest thing to do. His job is risk assessment on
7 the electricity system. He continually tries to balance the
8 transmission network and the energy side and makes certain the
9 risks are the right ones to take. That's Kevin and his
10 people's job. That's why he's been separated out within
11 Transpower to do it.

12 In the UK they have a two hour rule for generators.
13 They have very heavy incentives to force -- they've got a
14 margin -- they haven't got a marginal pool, they've got a
15 netter which is an average price pool, but they've got heavy
16 incentives to get the generators to over-contract so that
17 they're always over-supplying, and there's not a security
18 issue and they've still got a two hour rule. Our rules are
19 pretty light on preserving security compared with overseas
20 most places.

21 **CHAIR:** Without making too much obvious, given where there are
22 some transmission constraints, I guess you could argue that's
23 because of under-investment, just as an argument. I'm not
24 sure whether it's right or not.

25 **MR THOMSON:** Yes, but I said right at the start we invest for
26 security, not for price; if people want the market changed,
27 they should put the money in. We're going to cover new
28 investment later, Chairman.

29 **CHAIR:** We'll come back to it then.

30 **MR THOMSON:** We wouldn't say we're over-invested by any means. I
31 think we'd say we're under-invested.

32 **MR CURTIN:** I think we'll probably come to it in its place when
33 we're talking about the over and under-investment risks, but
34 certainly there are quite a few questions around that have
35 been raised in front of us.

36 **MS BATES:** I just want to clarify one thing with you, Mr Thomson,
37 which I asked right at the beginning, and it was related to
38 whether you thought there'd been under-investment in the last
39 ten years. Do I take it you don't mean there's been under-
40 investment in security?

41 **MR THOMSON:** It is I don't believe there's been under-investment
42 to preserve the security of the power system. But I think in
43 terms of constraints we're under-invested.

44 **MS BATES:** That's really what I wanted to clarify.

45 **MR THOMSON:** Peter's better than me on it, but that's where I
46 think we are.

47 **CHAIR:** That's a capacity issue.

48 **MR MACKEY:** Constraints can also arise by the behaviour of
49 generators alone. It's not just straight security. It
50 depends on the relationship between load and generation,

1 that's a pricing issue.

2 **CHAIR:** Things like voltage issues and so on. Let's come back to
3 the investment issue anyway we'll get further down the track.
4 I'd like to break in about four or five minutes, if we can
5 find a place to draw a line there.

6 **DR CRAUFORD:** I've just got a quick point to finish off what I
7 was saying. That relates to real time dispatch. Transpower
8 moved in 2000 from dispatch on a half hourly basis to real
9 time dispatch. That is a significant major change in the
10 dispatch process. That's something that Transpower could do
11 without the need for a rule change and therefore that was
12 something that we managed and we pushed through without any
13 involvement from NZEM.

14 **MS BATES:** While I've remembered my question can I just ask it?
15 Because I understand there is an international standard
16 relating to security, is that right?

17 **MR THOMSON:** Kevin's just reminded me. We get a three-yearly
18 audit conducted by an independent consulting engineering firm,
19 every three years, go right through our practices and compare
20 it with international standards. It was done last year by
21 Beca Carter and Sir Ron Carter, right, and the time before it
22 was done by Sinclair Knight Mertz I think. It's a report to
23 the board, they give a list of actions to be taken. It goes
24 into the performance standards for the company and it gets
25 done, chairman drives it very hard, all right.

26 **MS BATES:** So I suppose my question, what I'm thinking is, do you
27 adhere to international standards or do you go beyond
28 international standards?

29 **MR MACKEY:** The outcome of those audit reports has concluded that
30 the standards in New Zealand are comparable with international
31 standards and suitable for New Zealand. I also possibly make
32 the point about security. If you go back a number of years, I
33 mean it was solely determined by Transpower and its
34 predecessors. I think in more recent years the GSC has had an
35 input into that more or less as a consultative committee and
36 clearly under the new regime those trade-offs will be made by
37 the industry.

38 So, I think we're in transition from where we have
39 been. I mean clearly right at the moment the security of the
40 power system is the accountability of Transpower board and
41 consequently the risks are taken by the board and the
42 consequences of failure are accepted by the board.

43 **MS BATES:** I suppose what -- the international standard doesn't
44 bear on -- correct me if I'm wrong -- whether the security was
45 achieved in the most cost-effective and efficient way having
46 regard to everybody's interests?

47 **MR MACKEY:** That's correct, they tend to be engineering
48 standards.

49 **MS BATES:** Rather than an economic level.

50 **MR MACKEY:** Yes.

1 **MR ROBERTSON:** Can I just make the point as well, there is no one
2 international standard. If I drew the analogy to generally
3 accepted accounting practice, it's a concept and there's a
4 whole series of --

5 **MS BATES:** There's a range of views on that aren't there?

6 **MR ROBERTSON:** It's probably a bad example, upon reflection,
7 but --

8 **MR THOMSON:** It's really funny. When you look at the economics
9 of security, it becomes -- what actually happens is every now
10 and again there's a major breakdown, there's an inquiry, the
11 firm gets wiped. Politicians shift in and spend money like
12 water. You can point to three things in Australia like that,
13 you can point to Auckland, you can point to changing the
14 standards in 92 after the water shortage. It's very hard to
15 quantify in economic terms. There's a lot of engineering
16 judgment, and you've got to have that.

17 **MR MACKEY:** I think if you go back, I mean if you look at the
18 retail price of electricity it's around 14 cents. If you take
19 the Auckland debacle there a few years ago and looked at the
20 energy that was lost in the 150 odd million that it cost, you
21 end up with figures around \$4.

22 So, I think the point is, is that the value of
23 electricity to the end consumer is many many times the actual
24 price. That's really ultimately what drives security. I
25 think it's also other issues, there's other externals if you
26 like. If you go back to an unfortunate incident we had on
27 Waitangi Day in 1987 where we blacked out the upper half of
28 the North Island in the evening time. That actually led to --
29 that was a long time before the market, but it did actually
30 lead to rioting and looting.

31 So, there is obviously a public safety component to it
32 as well which is hard to factor it in. I think more recently
33 subsequent to the September 11th incident in New York, the
34 Government's actually set up a centre for critical
35 infrastructure protection, which is another input if you like
36 for the security power system, because the power systems are
37 recognised as being part of the country's critical
38 infrastructure, so there's a range of inputs if you like.

39 **CHAIR:** You'll recall the Y2K exercise too. But Donal Curtin has
40 one question and then I must close.

41 **MR CURTIN:** I asked you a slightly premature question about the
42 PJM market as you wanted to go on and say at least the FTR
43 introduction in that market was a good thing that you approved
44 of. The outstanding question was you liked that. But do you
45 have a view on the merits or otherwise of having a PJM style
46 market, FTRs governance, the whole nine yards in New Zealand,
47 or have you got a certain view on that market's design?

48 **CHAIR:** I wonder if you could start off tomorrow and perhaps
49 reply to that question first if it's possible. I'd like to
50 break now formally. Can we come back to answer that question

Transpower

1 in the morning? Thank you very much, we'll start at
2 12 o'clock sharp so I suggest people get a sandwich before
3 they come in and we'll work through from there.

4 **MR THOMSON:** Sorry I apologise Kevin's going on holiday to
5 Australia tomorrow.

6 **CHAIR:** That's fine. Thanks Mr Mackey for today. Thank you.

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[Hearing adjourned until 12 noon on 26 June 2002]

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