

[Commencing at 9.04 am]

PRESENTATION BY TRANSPOWER [continued]

CHAIR: I think we might be under way. Paula was on the 7.30 flight from Auckland so she'll be here as soon as it lands. I don't think she will be all that long. I think we should nevertheless get underway. So, Transpower over to you again please.

MS CALLINAN: Thank you Mr Chair. Just before we pick up from where we left off in relation to the conditions yesterday, there was one outstanding question by Commissioner Curtin in relation to wind power that Dr Crauford will answer.

DR CRAUFORD: Well, I've written a short note on it, so I wasn't going to go through that in great detail, unless you'd like me to. The major issue I think in terms of the -- there are both barriers and enablers to utilisation of wind power in the New Zealand system. One of the major barriers, I think, as perceived by the proponents of wind generation is our charging methodology, Transpower's charging methodology for the recovery of sunk costs. That is that the sunk costs are charged on essentially as flat a rate as we can get, a constant rate. That means for wind generation that when there is no wind, when they are not generating, then they are having to pay -- they feel as though they're having to pay for connection to the grid.

Our view would be that that is an economically efficient way of charging for our sunk costs and is consistent with the pricing principles in the GPS, but it is certainly a point of contention, they would prefer a kilowatt hour rate. The other consideration would be, well, if it was a kilowatt hour rate, how large would that be? I think it would not be quite as low as they seem to think that it might be. But that I think is the major contention.

Also, if there was a wind generation in the South Island then they would be charged a proportion of the HVDC charges, not that there are that many wind sites in the South Island. I think that was the major points.

One can get fluctuating voltage problems if you connect a lot of wind generation to the grid, but really we would need an awful lot for that to be a problem, that's not considered to be a problem. But one of the other issues is that with wind generation is often not a substitute for other forms of generation because you have to have some form of back-up when there is no wind.

MR CURTIN: Thank you for that.

MS CALLINAN: We'd like to just move on to conclude the comments that we have in relation to the conditions proposed by the applicant. We had covered off comments in relation to the conditions concerning the second vote and the rulings panel,

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1 and are moving now on to the conditions proposing an extension
 2 of the exemptions under the rules. It might just be useful if
 3 I go back to the comments of the Commission in its Draft
 4 Determination that we understand led to the proposal of these
 5 conditions.

6 At paragraph 257 of the Draft Determination, the
 7 Commission accepted that the common application of security
 8 dispatch and reconciliation provisions are necessary for the
 9 effective operation of the markets. However the Commission
 10 went on to say that there are other provisions which it
 11 understands need not apply to all non-members. In particular
 12 these are the operational provisions to the extent that they
 13 relate to administration, pricing and clearing services. The
 14 Commission does not consider that a case has been made for
 15 those to be mandatory.

16 In response to that, certain changes to the Rulebook
 17 were proposed by the applicant. To summarise that, the
 18 changes that were proposed is that Rule 3 in section 1 of
 19 Part G be extended so that the EGB may approve exemptions to
 20 all parts of Part G including pricing reconciliation and that
 21 there would be a new rule to be introduced to Part H so that
 22 the EGB may approve exemptions to clearing and settlement
 23 rules.

24 Now, what Transpower would like to do in relation to
 25 those is just focus first of all on the actual rule itself.
 26 In relation to exemptions, if we turn to Part G in relation to
 27 trading arrangements, simply because the condition allows an
 28 exemption in relation to these particular service functions
 29 doesn't necessarily mean that an exemption would be granted,
 30 because the relevant rule reads that:

31 "Any purchaser or generator may apply to the board for
 32 an exemption from full compliance with some or all of the
 33 rules in section 2 and 3 of Part G. Before granting an such
 34 exemption the board must satisfy itself that the exemption
 35 would result in such a benefit to the public that it should be
 36 allowed."

37 So the first point is really a procedural point, putting
 38 these services into the category where exemptions may be
 39 allowed under the Rulebook doesn't necessarily mean that
 40 exemptions will occur, the industry board still has that right
 41 to consider whether the net benefits test has been satisfied.
 42 That's the procedural point, but Transpower would just like to
 43 explain some more substantive issues with making these
 44 particular services potentially be provided outside the
 45 Rulebook through an exemption. In dealing with that we just
 46 want to group the services into two categories. Mr Heaps will
 47 speak briefly about clearing settlement and reconciliation and
 48 Mr Robertson will just deal briefly with pricing.

49 **CHAIR:** Mr Heaps please.

50 **MR HEAPS:** We think that this exemption rule is a bit of a

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1 sledgehammer to crack a nut and we're not really too sure
2 about the nut that we're trying to crack, but we do think
3 there is a danger using a sledgehammer that we will damage the
4 foundations of the market. In particular, reconciliation is a
5 good example of that because the reconciliation, of course, is
6 the allocation of quantities to buyers and sellers, and the
7 rules around reconciliation, there can only be one set of
8 rules. It's like driving on the left-hand side of the road.
9 On a common system you have to have a common set of rules for
10 driving.

11 On an islanded system, totally separate, you can have a
12 different set of rules, you can drive on the right-hand side
13 of the road. For reconciliation of quantities to buyers and
14 sellers on the electricity system there can only be one set of
15 rules. There can be alternative service providers and
16 currently Transpower's subsidiary Decipher is the national
17 reconciliation manager through a contract to the NZEM, but
18 that contract is contestable. It's been contested once and
19 Decipher won that in the competition and it will be presumably
20 contestable in the future.

21 But the rules around reconciliation have to be common.
22 So, there can only be one set of rules and we can't see how
23 that can be contestable. You can't drive on the left and the
24 right-hand side at the same time.

25 **CHAIR:** So you're saying within a common set of rules, some of
26 the functions within that framework are contestable, that's
27 the point you're making.

28 **MR HEAPS:** The service provider for that function. That
29 currently is the case. It would be the case under the
30 proposed rules and it would be the case under the
31 counterfactual. So, we can't really see why an exemption is
32 needed there. Clearly in the settlement is a similar sort of
33 arrangement where there can be contestability, and the
34 administrator and the provider with the clearing and
35 settlement functions, but the clearing and settlement itself
36 is common to all that are actually in the market, unless you
37 have an isolated system.

38 **CHAIR:** Presumably NZEM would have a view on this as well. They
39 may cover it in their submissions.

40 **MR TAYLOR:** What was your exception there Mr Heaps?

41 **MR HEAPS:** If you have a totally islanded system.

42 **MR TAYLOR:** Again the left and the right.

43 **MR HEAPS:** Again it would have to be separate, so Stewart Island
44 can have its own system, or the United States can, but
45 New Zealand has to have a common system.

46 **MR TAYLOR:** No, I understand.

47 **MR HEAPS:** We think there are some very important foundations to
48 the market, some very important common foundations and Peter
49 will describe those.

50 **MR ROBERTSON:** I'm referring to a diagram that was originally in

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1 our submission to the inquiry, the original inquiry into the
2 electricity industry, which we colloquially refer to as the
3 "grapes diagram". But, in essence, in that diagram what we
4 attempted to convey was the sort of foundation of the
5 electricity market design that we have in New Zealand and in
6 essence what that recognised was that as a fundamental
7 underpinning of the market you had to have quality and
8 security. Electricity had to get through, it had to be
9 reliable, and one of the cornerstones of that is the
10 requirement to match supply and demand in real time.

11 From a system operator's perspective, the requirement to
12 match supply and demand can be met in any number of ways. You
13 can take any number of configurations of generation to meet
14 the demand. Equally you could do things on the demand side to
15 match the available generation. So, in our market, there is a
16 question as to how is the system operator to make that
17 judgment? Which configuration should it select?

18 In the past where we had a centrally planned system the
19 system operator used to have reference to merit order which
20 was an engineering based assessment of the marginal cost of
21 generating plant. So that the system operator would use base
22 load plant first and then add plant into the dispatch until
23 the point that the demand was satisfied.

24 In 1996 when we moved to our current form of wholesale
25 market we moved away from the centrally planned dispatch
26 process to a market based dispatch process, which essentially
27 carried with it a vote of confidence or an act of faith, if
28 you will, in the market processes, and the forces of
29 competition, as a better more robust determinative of the
30 marginal cost of plant.

31 So, our system operator now achieves that real time
32 match of supply and demand by reference to an algorithm that
33 balances, or seeks the intersection of demand and supply,
34 based on offers of generation and bids from the demand side.
35 In so doing they essentially pile into the dispatch order each
36 of those generating plant which is offered up until the last
37 unit at a price which will clear the demand.

38 Now, what I'm really trying to point out in that process
39 is that the algorithm which determines dispatch also
40 determines price. So, we find ourselves a little bit
41 confused, to be honest, as to what's proposed in offering some
42 alternative to pricing. If there is some issue about the
43 services, again replicating Bill's comment, if there's some
44 issue about the services relating to pricing, I can't imagine
45 what those might be, but there's no inherent reason why they
46 can't be contestable. But the rule around which price is
47 struck is absolutely integral, is a derivative of the
48 algorithm by which dispatch is achieved and real time supply
49 and demand are balanced.

50 **MR HEAPS:** That then is the spot price that's produced. Of

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1 course there can be bilateral trades to manage the risk around
2 the spot price, but the spot price comes out of the Merit
3 Order Dispatch.

4 **CHAIR:** Is the rule -- you talked about part of the market
5 framework that's part of the Section 30 argument as well in
6 establishing that spot price.

7 **MR ROBERTSON:** Presumably it is, I have to confess I'm not deep
8 into the Section 30 argument.

9 **CHAIR:** No, but I think part of the section 30 argument, or one
10 of the issues is the degree to which the market rules
11 influence or not the actual price that is discovered as
12 against the supply and demand reacting within the market
13 rules. We'll have to work that through anyway.

14 **MR ROBERTSON:** I think the comment Bill was making in relation to
15 the spot price in the current market design we have is, just
16 to repeat, a derivative of the dispatch process and there is
17 complete freedom, from a financial point of view, to layer
18 financial bilateral contracts over the top of that.

19 **CHAIR:** In that context, yeah. Thanks Mr Robertson.

20 **MS CALLINAN:** That really concludes the submission in relation to
21 conditions. We'd like to move on to Alex Sundakov who will
22 discuss the overall benefits and detriments from Transpower's
23 perspective.

24 **MR STRONG:** I wonder if just before you move on if I could just
25 come back to an issue that we had discussed yesterday on
26 transition dispensations, because I'm just a little unclear on
27 that. You characterise it as being something that's anti-
28 competitive. I mean I think there's also a broader principle
29 at stake here, and that is how parties are compensated where
30 there's a rule change that affects asset values. If you look
31 at the transition dispensations you could in a sense look at
32 this as being a way of compensating existing asset owners,
33 presumably they're connected at a standard, or when they're
34 connected they're connected at the standard that was
35 prevailing at the time. Since then there has been changes in
36 those standards and as a result of that there are costs of
37 meeting the new standard. It's a question of who bears those
38 costs.

39 One way of looking at it would be it's appropriate to
40 compensate them for having to bear those additional costs and
41 you can do that in a number of ways and the proposed
42 arrangement to me seems to be spreading those costs over all
43 asset owners and that may be sort of a reasonably efficient
44 way of going about it. So, it's not clear to me that there's
45 something inefficient in that.

46 Then if you look at new entrants connecting at the
47 prevailing standard, if they want to connect with non-
48 complying assets, they impose a cost on the system and surely
49 they should have to bear that cost, since, I mean -- otherwise
50 you get uneconomic generation connecting. So, it seems to me

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1 that that entire transition dispensation seems entirely
2 consistent with sound economic principles. The suggestion
3 that a Crown EGB would look at this differently and say to
4 incumbent asset owners, "look we're raising the standards, you
5 bear the costs", would simply raise the cost of capital for
6 new investment.

7 **DR SUNDAKOV:** I think I should turn that around though. I think
8 the way you need to think about this is that compensation for
9 incumbent asset owners is itself a feature of non-competitive
10 markets, it's not something you observe in competitive
11 markets. Standards change all the time, preferences change
12 all the time. In the competitive market once you've
13 undertaken your investment no-body's going to come back and
14 compensate you for that.

15 The question therefore is what would be the difference
16 in terms of forward looking investment incentives and the
17 difference is that where incumbent asset owners are
18 compensated -- there are two things that can happen obviously.
19 The one is -- there are two types of investment that can
20 occur. One is the type of investment that can occur where
21 demand load grows and new investment has to come in, and the
22 question is whether that investment will come in from the
23 incumbent operator or whether a newcomer into the market will
24 undertake that investment.

25 In that regard there's no difference. Traditional
26 dispensations doesn't affect that at all. But if you're
27 thinking of competitive pressure, one of the things that can
28 occur, if somebody comes up with new technology for example
29 and wants to undertake investment which would produce lower
30 marginal cost of energy, without the overall base growing.
31 What they would expect to do is to come in and undertake that
32 investment and be able to compete with the incumbents for the
33 existing level of demand. In other words, in a sense take
34 business away from the incumbents and perhaps make some of the
35 incumbents investments redundant. The way the traditional
36 dispensations are structured is that it provides a form of
37 protection for the incumbents against having their investment
38 being made redundant.

39 **MR STRONG:** Presumably the standards have been changed so that
40 new technologies which are cheaper have the lower marginal
41 costs can come in without needing any sort of dispensations or
42 additional ancillary services.

43 **DR SUNDAKOV:** No, but the question though is, I mean let's say
44 there are two types of technology. Hopefully, I mean we've
45 spent some time talking about this, I hope engineers will help
46 me with this. If you think of two types of technology which
47 have different marginal costs but impose the same level of
48 risk in relation to maintaining voltage in the system, and the
49 incumbent technology has higher marginal costs than the new
50 technology. But the newcomer has to carry the full costs of

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1 dealing with the voltage risk, whereas the newcomer has some
2 of that risk spread around and therefore the compensation for
3 the risk may well equalise the marginal cost and make new
4 entrant relatively unviable. Whereas if they were competing
5 on an unprejudiced basis, in other words if both were carrying
6 the direct costs of the risk they're imposing on the system,
7 then the newcomer would be able to come in and take the
8 business away from the incumbent.

9 **MR STRONG:** I think I understand where you're coming from.

10 **DR SUNDAKOV:** I don't know if there's an engineering explanation
11 that will do any better.

12 **CHAIR:** Thanks Nathan.

13 **DR SUNDAKOV:** What I'd like to do is pretty quickly go through
14 the summary of estimates of detriments and benefits on page
15 10. I don't envy the staff who put this together the need to
16 try to quantify the various subtle differences between these
17 two arrangements. People spent life times doing that kind of
18 research and if you get it right it's Nobel prize winning
19 work.

20 I think what we've tried to do rather than address the
21 foundations of where the numbers have arrived from, what we've
22 tried to do was to take the Commission's numbers for different
23 categories of benefits and detriments and on the basis of our
24 analysis suggest which way you need to be leaning, taking that
25 as a basis. I think that the results are reasonably
26 predictable from where we have come in on the analysis of
27 different elements of benefits and detriments.

28 What I'd like to say, though, I think is that as our own
29 analysis and discussion with the Commissioners over the last
30 few days have shown, clearly the -- sometimes it's very hard
31 to draw distinctions between the proposal and the
32 counterfactual, depending on how you assume the Government is
33 going to operate, depending on what you expect, say, the
34 Auditor-General to be able to achieve or how the Minister's
35 likely to behave, the proposal shades into the counterfactual
36 and it's often difficult to draw the line.

37 Commissioner Bates referred to MEUG saying they want an
38 industry EGB. I went back over the transcripts, and what they
39 seem to want is an industry EGB which has all the
40 characteristics of a Crown EGB. It's very very hard to
41 interpret exactly where one ends and the other one begins.
42 So, what we tried to do in undertaking this numerical
43 comparison is to focus -- accepting that one shades into the
44 other, nonetheless you've got it make a distinction between
45 the proposal and the counterfactual.

46 So, we tried to draw the key distinction and analyse the
47 numbers from the point of view of what these likely key
48 distinctions are going to be, if the proposal indeed is
49 different to the Crown EGB.

50 One of the key distinctions that seems to be is distance

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1 from Government. In other words the proposal must by
2 necessity make the industry EGB somewhat more distant from
3 Government involvement and Government oversight than a Crown
4 EGB would be. In other words, yes, you can imagine the
5 Government taking a very active role, you can imagine the
6 Government investing quite heavily in various processes
7 through the Auditor-General, through Ministerial advisors and
8 so on. But at some stage the Government, if one is to draw a
9 distinction, if there's a really a difference between the
10 proposal and the counterfactual there has to be a point where
11 you say well no, in the proposal the industry EGB is going to
12 be more distant from the Government, it's going to have less
13 Ministerial oversight, it's going to have less involvement
14 than the Crown EGB, otherwise you just can't make any
15 distinction here.

16 What that means, I think the second key distinction, is
17 that the Crown EGB will be closer to the Government and the
18 industry EGB -- the decisions made by the Crown EGB will be a
19 closer reflection of Government policy, whereas the decisions
20 made by the industry EGB will be a closer reflection of the
21 outcomes of voting processes.

22 Now, obviously these are not absolute distinctions, the
23 Crown EGB will not make decisions that are entirely divorced
24 from industry's wishes and equally in the outcomes of its
25 voting processes the industry will not entirely ignore the
26 Government's wishes. But again if we're to draw a distinction
27 you've got to say where does the difference lie? It has to
28 lie in the outcomes of the industry EGB processes being more
29 influenced by the voting choices of the industry and less
30 influenced by the Government than the other way around.

31 So, on that basis, we've gone through the numbers, as
32 you can see on page 10, we have tried to present a broad
33 assessment of where one should be leaning in terms of the
34 numbers. I will just go through these broad headings.

35 We discussed the cost of capital issue yesterday. We
36 just think that's simply an error that needs to be taken out.
37 In terms of the improved quality of decision-making, I think
38 all the discussion that we've gone through suggests that the
39 differences are going to be illusory, the Crown EGB is going
40 to have a very powerful incentive to use the best industry
41 information available to use working parties wherever that's
42 feasible. But nonetheless, we think that, yes, if one is
43 drawing the distinction of saying that the industry EGB is
44 somewhat closer to the industry than the Crown EGB, then I
45 think one has to allow for the possibility that at the margin
46 there will be slightly better decisions that may be able in
47 those few areas where the distance from industry would be a
48 problem for the Crown EGB. But we think that, you know,
49 you're really talking about an order of magnitude of
50 difference here to the original estimates.

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1 I think we have addressed the issue of lower transaction
 2 and compliance and lobbying costs, essentially we just simply
 3 see no difference. Compliance costs and transactions costs
 4 are likely to be relatively high in both processes. In fact
 5 one of the shifts from the central planning arrangement that
 6 exists to the electricity market has been a dramatic increase
 7 in transaction costs. The objective of the shift, though, is
 8 that even though the market processes in the electricity
 9 sector produce much higher transaction costs than central
 10 planning, you're hoping that it's going to result in better
 11 investment outcomes. So, it's trade-off that's already been
 12 made and we don't see any significant difference here.

13 **CHAIR:** Is that based on empirical evidence given that the costs
 14 under the old central planning mode were not identified at
 15 all, particularly indirect costs wouldn't even have been
 16 thought about I wouldn't have thought.

17 **DR SUNDAKOV:** From the work we have done for Transpower in the
 18 past there has certainly been an increase in what you would
 19 identify as transaction related overhead costs. But that's
 20 been, I think, largely offset by more efficient investment in
 21 some production cost savings.

22 Avoidance of over-investment in transmission. We have
 23 argued that there's very unlikely to be any difference,
 24 because the difference really comes down to those very few
 25 cases where, under the Crown EGB, more investment decisions
 26 may come back for appeal than under the industry EGB, but the
 27 appeal process itself is going to be biased against making
 28 inappropriate decisions. But, again, one could argue if more
 29 cases do come back for appeal, maybe somewhere at the margin,
 30 some things may slip through that wouldn't have occurred
 31 otherwise. So, we think again it's an order of magnitude
 32 lower than has been originally there, but, you know, perhaps
 33 some numbers should be put for that.

34 We have made the point that we don't see any difference
 35 in the likely competition of transmission services between the
 36 counterfactual and the proposal, simply because the processes
 37 for arriving at a decision on when to use a competitive
 38 provider are going to be exactly the same.

39 Equally I'd just like to emphasise again that in our
 40 view, and given some more thought after discussion yesterday,
 41 that competition and provision of other services, there's also
 42 unlikely to be any difference. Particularly I think yesterday
 43 there was a discussion about the system operator role, and
 44 I've gone back to the GPS and had another look at it. It
 45 seems to me that it's just very hard to see how there can be
 46 any difference between the proposal and the counterfactual.

47 The GPS very explicitly says that the Governance Board,
 48 presumably that would apply equally to the industry Governance
 49 Board and the Crown EGB, may make recommendations from time-
 50 to-time to the Government as Transpower's owner on making

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1 those services contestable. So, it very clearly puts the
2 Government's ownership interest in Transpower at the centre of
3 the process. Now, the same would apply under both Crown EGB
4 and the industry EGB. At the end of the day it's the Crown as
5 the proprietor of these assets will have to make a decision.
6 If the industry EGB is going to be audited for compliance with
7 the GPS, it seems implausible they would be able to proceed
8 without, on this clause of the GPS, would be able to proceed
9 without getting the Crown's agreement if it were to, say, to
10 make the system operator role contestable.

11 Moving on to detriments now. I think that we've
12 discussed the risks of under-investment in transmission. I
13 think that the point we wanted to make here is that, I think
14 this is a point I made earlier, that, yes, it is helpful in
15 some ways to separate the components of benefits and
16 detriments, as has been done in the Draft Determination, but
17 it's also important to keep in mind that they are very closely
18 interlinked and in some ways it may not so much as additive
19 but multiplicative, that problems may snowball.

20 I think certainly my interpretation of the US experience
21 is that this is not a type of industry where things goes
22 slightly wrong. Either things go very well or things go
23 spectacularly wrong. I think in that regard one has to be
24 very cautious about not missing those interconnections.

25 So, we think that certainly in terms of looking at the
26 under-investment in transmission, the risks are at the higher
27 end. We've talked about the strike down of pro-competitive
28 rules and the development of anti-competitive rules, they're
29 just two sides of the same coin. I think transitional
30 dispensations is a good example of the sort of risks one is
31 running. In this case we're probably talking about relatively
32 small amounts. My understanding is that the cost of voltage
33 support is a couple of million dollars a year, so the
34 imposition from transitional dispensations may not be all that
35 significant, but these things can accumulate. So, if a little
36 bias for incumbents can slip through over time, these biases
37 may build up.

38 I think we would also clearly raise the issue of
39 transaction costs that may be involved in comparing the
40 industry EGB that would need to interact regularly with the
41 Commerce Commission, and I think that the last couple of weeks
42 have convinced us all just exactly what those costs are. I
43 think that any ambiguity in the scope of authorisation and the
44 likely need to return for further authorisations to deal with
45 ongoing evolution of rules needs to be built into the
46 calculus.

47 Finally, there's been sort of a lot of qualitative
48 discussion about lack of mandatory coverage and both the risks
49 -- and this is probably were the risks can multiply very
50 quickly as well as the transaction costs involved in trying to

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1 bring in those who may stay outside the system, wouldn't even
 2 try to quantify that. But I think, again, it's a number that
 3 can be anywhere from relatively small to potentially very
 4 large and can't be entirely dismissed.

5 So, on balance it seems to us that the -- and again I
 6 come back to the point that if one is to make a distinction
 7 between the proposal and the counterfactual, without sort of
 8 allowing one to shade into the other, then it seems that the
 9 detriments of the proposal outweigh its benefits.

10 **MS REBSTOCK:** Can I just ask you a question. One of the points
 11 that have been made by various parties is that the proposal
 12 has a weakness in that the governance arrangement involves
 13 split or confused accountabilities. From a governance
 14 perspective I think it's probably well understood what that
 15 may lead to, but one test on these detriments is to think
 16 through what are the implications? If it's right that there
 17 are split or conflicting accountabilities within the proposal,
 18 do the detriments pick up what we think might arise from that.

19 So, I put the question to you. Do these detriments, as
 20 you have described them, take full account of what has been
 21 suggested as the detriment associated with the governance
 22 regime with possibly conflicting accountabilities?

23 **DR SUNDAKOV:** I think they're likely to in the sense that all the
 24 headings here, when you add them up, cover -- I see the risks
 25 essentially being three-fold. One has to do with investment
 26 in common assets and that's one of the key risks of split
 27 accountabilities, that things will fall through the cracks.
 28 The other one is the possibility of self-interest at the
 29 expense of the outsiders, incumbents taking advantage of those
 30 outside the club. The third one is simply the transaction
 31 costs as far as dealing as far as possible with those split
 32 accountabilities.

33 For example, again, coming back to the possibility that
 34 one, the proposal shades into the counterfactual where the
 35 Government invests very heavily in parallel monitoring and
 36 effectively recreates the same knowledge and the same
 37 decision-making investment that the industry would be making
 38 in order to keep an eye on what's happening in the industry.
 39 It may go along way towards resolving the accountabilities,
 40 but it's a pretty high cost of doing that.

41 **MS REBSTOCK:** One of the things that comes to my mind when I
 42 think about this is, we can think about what are the sort of
 43 worst case scenarios that will happen under the proposal or
 44 the counterfactual. But another question you might ask is
 45 what if something goes wrong? What do the governance
 46 arrangements tell us about how we would manage in a crisis.
 47 Because we see crises happen in both regulated and unregulated
 48 environments.

49 So, in addition to the basic point, I want to also ask
 50 you the question, we can all talk about these proposals in the

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1 governance arrangements and to what extent do they avoid
 2 undesirable events. Let's ask the question, what happens in
 3 the case of an undesirable event, under either scenario? What
 4 does the governance structure lead to in terms of management
 5 of a crisis, or an adverse event?

6 **MR THOMSON:** Can I -- we have formally studied and I've had
 7 internal reports on the gas outage in Australia, right. There
 8 was a major outage in Perth, Malaysia, Auckland, and my
 9 chairman has discussed it with me verbally when it's happened.
 10 The CEO gets one week and the chairman gets two weeks to fix
 11 it. After that, in every case I've seen, a Government moves
 12 in, doesn't matter about rules or anything else, they ignore
 13 economics and efficiencies and they overdo the inputs and
 14 you've only got to look at Auckland and a lot of -- there's a
 15 reaction against what happened and a lot of extra goes in.
 16 Inefficient investment I suppose you'd call it, and you can
 17 see it out of the 92 water shortage in New Zealand where the
 18 security standard was upped to about a one in 30 dry year from
 19 a 1 in 60, something like that, what was it? 1 in 20, and
 20 there's a reaction the other way. But every time a Government
 21 steps in.

22 **MS REBSTOCK:** My question to you is, is that reaction, and the
 23 outcomes that flow from it, different under the proposal as
 24 compared with the counterfactual?

25 **MR THOMSON:** No.

26 **MS REBSTOCK:** Is there anything that's likely to be different?

27 **MR THOMSON:** I don't think it is, is it? Peter? You go, we
 28 don't always agree.

29 **MR ROBERTSON:** What can I say?

30 **MS REBSTOCK:** What I'm asking you is, is there greater potential
 31 for industry players to provide an adequate response to avoid
 32 this overreaction of Government in a crisis under one model or
 33 the other, or is the dynamics such that under both cases
 34 parties, whoever they are, will have a week or two weeks to
 35 sort it out, if they don't the Government steps in.

36 **MR THOMSON:** They sack them frankly.

37 **MS REBSTOCK:** Yeah, but within that two week period is there more
 38 likelihood under this proposal, or the counterfactual, that
 39 the people who are accountable and who can fix the problem
 40 will be more likely to be able to do it?

41 **MR ROBERTSON:** My response, for what it's worth, just I guess a
 42 matter of opinion, is that the more direct and unambiguous the
 43 accountabilities, the greater the ability to deal with crises
 44 and that on the one hand, as I interpret the proposal, there
 45 is ambiguity over accountability, that can lead, in my view,
 46 to, if you like, tensions building up during the period that
 47 precedes the crisis and therefore when the crisis hits I would
 48 suggest that reactions might be unfortunately delayed in the
 49 process of finger pointing that follows the immediate impact
 50 of the crisis, and that therefore reactions might be delayed.

Transpower (cont)

1 **MS REBSTOCK:** One of the questions I really want to follow-up
2 with Mr Thomson. If it's right that Ministers, or the Crown,
3 or Government in whatever form, has a tendency to step in and
4 over-invest in a crisis, isn't that more likely to happen when
5 a Minister as direct decision-making power than when the
6 industry, at least in the unfolding period, has the
7 opportunity to address the issue?

8 **MR THOMSON:** Not that I've seen.

9 **DR SUNDAKOV:** I think that -- sorry.

10 **MR THOMSON:** Can I follow through on Peter. In the Auckland
11 outage, when that happened, there were critical delays in the
12 timing because Mercury at the time would not put a line up.
13 In the finish, I think the Prime Minister wrote to them and
14 told them what to do. I mean I got sent up with Kevin Mackey
15 and Mike Lear to investigate that. That led to critical
16 delays in fixing the problem. I mean the sooner a line got
17 in, the sooner the problem was over. That kept going for two
18 or three weeks. It was quite clear early on that the line was
19 viable. Now, I agree with Peter that direct control gives you
20 better results, it's pretty clear management stuff.

21 **CHAIR:** But you contrast that with the water shortage in 92,
22 where there was direct control, as I recall it, and it took
23 some months before the magnitude of that water shortage was
24 actually revealed apart from action taken, and that was when
25 the whole system was together.

26 **MR THOMSON:** Yes, but that's really a fault of non-disclosure of
27 information. Under any system it would be the same.

28 **CHAIR:** But the accountability was very direct then. There was
29 one body, ECNZ, which was also the grid and the accountability
30 is quite clear, but the delays in coming up with what the
31 shortage meant and indeed a response to it I think were no
32 less than the delays in the Mercury situation.

33 **MR THOMSON:** They didn't put the pipeline in until much later. I
34 mean you know that there was a report done and Ron Carter
35 actually said "don't put it in, not needed". I think that's
36 what he said.

37 **CHAIR:** Well, I wasn't at the inquiry obviously, some of the
38 Ministry people were. But under a direct control
39 accountability regime the delays and procrastination before it
40 was identified and then responded to were not too different in
41 the Mercury situation.

42 **MR THOMSON:** I'd put that down to management. There's no doubt
43 that management operates a lot better if you've got direct
44 accountability and direct control. I mean it's really clear-
45 cut.

46 **CHAIR:** But that was direct accountability and direct control.

47 **MR THOMSON:** Yeah, but it's the quality of management as well. I
48 think if you've got bad management under either situation
49 you'll get bad results. If you've got good management under
50 one situation you'll get good results. If it's under another

Transpower (cont)

1 situation you're likely to get bad results. I've been
2 managing a long time.

3 **CHAIR:** So have I.

4 **MR THOMSON:** And I always -- you know, okay, call me a control
5 freak --

6 **MR CURTIN:** You're a control freak.

7 **MR THOMSON:** -- but the key variables I want to have control
8 over.

9 **DR SUNDAKOV:** Perhaps if I -- I had a chance to think while the
10 others were talking, I'll try answering the question. I think
11 where I can see a difference is that when a crisis occurs and
12 the Government steps in to solve the crisis, there are two
13 elements of that stepping in. One is actually resolving the
14 problem, the second one is people are usually baying for blood
15 and in part the overreaction is driven by the need to allocate
16 blame and deal to people who are somehow found to be at fault.
17 I think some of the unfortunate effects you get of the
18 overreaction stem from that. The Auckland power crisis, I
19 think where the overreaction has occurred and where probably
20 the biggest problem from that overreaction has been is that
21 it's blackened the name of privatisation, it's made further
22 privatisation of lines companies much more difficult and
23 therefore has had an inefficiency impact through that.

24 **CHAIR:** But it wasn't a privately owned lines company.

25 **DR SUNDAKOV:** No, but that's now it was perceived and that's how
26 the Government in some ways played it, because that was a way
27 of blaming somebody else. Whereas I think the point I'm
28 trying to make is when the Government is accountable from day
29 one, there's no point in ramping up the blame on itself. So
30 the intervention is likely to be somewhat more focused on
31 dealing with the problem.

32 **MR HEAPS:** Could I add from my experience, because I manage sort
33 of pre-crisis working groups in Auckland when Otahuhu B power
34 station failed and I've also been managing the steering group
35 looking at this winter with the rain coming down isn't too
36 critical now, but it had the potential of being. I think from
37 my experience it's the timing when intervention occurs when
38 you actually call it a crisis which is quite crucial.

39 This winter, and the experience we gained from last
40 winter, was it was the time when the thermal power station's
41 coming on, the time when the Ministerial intervention was
42 quite important. So, actually monitoring situations as they
43 develop and knowing when you have to take action, contingent
44 action, is very important. I made an individual submission on
45 the rules on the first submissions because I believe that the
46 management of crisis and the monitoring when that management
47 has to take place wasn't included in the processes under each
48 of the chapters. I still believe that's the case. There is
49 nothing in the application which actually manages a crisis,
50 nothing in the processes.

Transpower (cont)

1 **MS REBSTOCK:** What I really was hoping to focus your minds on,
2 and I thought you might have worked through this in terms of
3 risk management strategies; what sort of scenarios could
4 develop? I'm sure that you've got some risk assessments of
5 different scenarios that might develop. Under the proposal,
6 have you thought about whether or not those people who have to
7 make decisions would have the ability to do it in a timely
8 fashion. This is really the question. Would they have the
9 authority to make the decisions that needed to be made, or
10 would, if things had to involve rule changes or whatever,
11 would we be going through voting processes in order to get the
12 decisions made? Are there anything in these risk scenarios
13 that you look at that suggests that timeliness would be a
14 problem, given the voting structure of the proposal? This is
15 the issue that I was trying to point you towards, so I'll make
16 it more explicit. Because I think in raising the issue of
17 timeliness it's coming, you know, it is coming on to that
18 point. So I'll be clearer in what I was trying to get at.

19 **MR HEAPS:** Maybe this example works. In Auckland when Otahuhu B
20 power station failed, so we were facing a summer of some
21 uncertainty there, we also gained confidential information, so
22 I gain that, the system operator and Transpower gained
23 confidential information that the Stratford power station was
24 facing a catastrophic failure also in its turbines and its
25 output had to be cut back and it needed a 30 or 40 day outage
26 in January/February, which was the critical time for air-
27 conditioning loads in Auckland.

28 We also had some information on an outage of the gas
29 system from Maui which was going to coincide at the same time.
30 This was all information provided confidentially. It couldn't
31 be shared because of the commercial positions and hedging
32 positions of the parties that were involved in actually
33 gaining hedge cover and managing the commercial positions.

34 There is nothing in the application in the rules that
35 tells me how that commercial information will be handled
36 currently. It was provided to Transpower on a confidential
37 basis. The risk that we run because that information had to
38 be confidential was that we couldn't build up the concern
39 around the situation. All of the projections showed well it
40 was just the Otahuhu B power station out and Auckland was
41 okay, but if you built on to that the information that we had,
42 then it became far more critical. So, we had to determine
43 then who we shared that information with to enable us to
44 manage the situation and get things like contingency plans
45 underway.

46 **MS REBSTOCK:** Is there anything in the rules that suggests that
47 providing that information to Transpower would not be
48 possible, that allows Transpower then to brokerage a solution?
49 Is there anything in the rules that suggests that couldn't or
50 wouldn't happen?

Transpower (cont)

1 **MR HEAPS:** I think you're really starting to ask me to make
2 assumptions on what would happen there.

3 **MS REBSTOCK:** Well, we're making a lot, we do have to make a lot
4 of assumptions.

5 **MR ROBERTSON:** Just I wonder if -- as an example, one of the
6 issues that we perceive to be a problem under the rules is
7 that the system operator, as an example, is able to comment on
8 proposed rule changes but that's it. Our experience, if I put
9 aside sort of damaged pride and ego, but our experience of
10 this whole process has been that we comment, but that comment
11 in the end reduces to a vote, one vote. So there's been a
12 long track record that Mr Thomson referred to, I think in his
13 opening remarks, of loss of votes in this process.

14 The proposed exemptions to Part G that we opened this
15 morning commenting on, we could look at as a case in point.
16 Because the background to those proposed conditions was they
17 were discussed at an EGENC meeting, a point was raised there, a
18 point of due process I guess you would say, that the proposals
19 needed to be considered in the context of the overall
20 framework of the rules and that the GWG was the subcommittee
21 charged with doing that. So it was suggested that those
22 proposals be put to the GWG for consideration.

23 The third proposal which dealt with the proposal to
24 change the rules relating to, or allow for exemptions in
25 relation to clearing of pricing and so on, was a matter that
26 had been considered at the rationalisation working group.
27 That was the body that had the expertise to properly consider
28 that issue. I pointed that out and in point of fact the GWG
29 never actually met, there was an exchange of e-mails. I
30 pointed out that the body competent to deal with that issue
31 was the rationalisation working group, but in the interests of
32 time that point was overridden, if you will, and although no
33 vote was actually taken formally, a majority in favour was
34 reported to EGENC and hence the conditions were proposed.

35 **MR THOMSON:** Commissioner, there's two security issues that cause
36 you problems. One's short-term and I think, I'm not certain
37 of the rules, but I think the system operator will have a bit
38 of power there. But the ones that cause you the real trouble
39 are the medium term investment rules. Auckland was investment
40 and I'm certain the counterfactual is, in my own mind, I'm
41 certain the counterfactual is better than the industry one
42 because of the control mechanism. But that's my opinion.

43 **MS REBSTOCK:** Just looking at Part A, 5.2.2 under "other matters"
44 and it says.

45 "Where the rulings panel considers that the subject
46 matter of a hearing involves a significant area of dispute or
47 a matter of urgency will arrange for a hearing to take place
48 as soon as practicable after the application for the hearing
49 is made."

50 I'm not sure if this is entirely what we rely on. I

Transpower (cont)

1 think there's something also in the Act with respect to the
2 industry EGB --

3 **MS BATES:** Can I just chip in there. I stand to be corrected on
4 this, but my reading of the legislation is that there is a
5 provision under EGB, I think it's 172.E.3 under Crown EGB
6 which allows the Crown EGB and Ministers to make regulations
7 if -- and bypass the consultation process in emergency
8 situations -- if it considers it necessary or desirable in the
9 public interest. You've also got another provision, which is
10 -- let me just find it, which applies both to Crown EGB and to
11 industry EGB, which allows the Minister to come in in an
12 emergency and make emergency regulations. I'll find the
13 reference to that in just one moment. So, I just thought it
14 would be useful to put the legislative framework for you.

15 **MS REBSTOCK:** I think what I hear Mr Thomson saying is, this all
16 talks about what the Crown may be able to do in an emergency,
17 but it does seem to me that -- I think there is some validity
18 to the notion that when the Crown, if things aren't sorted out
19 and the Crown has to step in, you do tend to get an
20 overreaction, which is not necessarily in the public's
21 interests.

22 So, the question is, leading up to that point which
23 governance regime gives you a more effective ability to deal
24 with a crisis, whatever nature of crisis it is? I take it
25 from Mr Thomson that he believes, and tell me if I'm wrong,
26 but because of the issue of clear accountabilities, you would
27 prefer the governance structure in a crisis of the Crown EGB
28 to the industry.

29 **MR THOMSON:** Yes. I've been through a lot of crises, right, and
30 if you've got control you can generally -- you can do your
31 best anyway and you've got bright people that get you out of
32 it.

33 **MS BATES:** Just for the sake of completeness it was 172.G.3 which
34 applies whether there's a Crown or an industry EGB, but would
35 involve someone convincing the Minister that the situation was
36 sufficient to exercise that power. In fact they're fairly
37 similar powers when you get to that point under either, but
38 that's addressing urgent situations.

39 **MR THOMSON:** Look, I know I'm taking time, but I go back. We had
40 a major outage in the Bay of Plenty where we lost a
41 transformer and it was going to be out for a week. I always
42 remember Mr Bradford ringing me up and saying, "you get it
43 fixed in a day Bob otherwise there's a full inquiry." One of
44 my engineers came up with a brilliant solution. It was direct
45 control. I told the Chairman straight away, right, and he
46 agreed completely, if you know what I mean. It's that
47 directness under emergencies that you definitely do need. If
48 you have to go through damn committees and, well, it's very
49 difficult, all right. I'm sorry.

50 **MS REBSTOCK:** I've pursued this this far because it does seem to

Transpower (cont)

1 me we've focused a lot on what does the governance regime do
 2 in terms of preventing problems. We've done very little
 3 addressing, well what if something goes wrong, and I
 4 appreciate your input on that, and I certainly hope that the
 5 applicant will also address this issue, because I don't think
 6 it's been adequately addressed thus far in the hearings.

7 **CHAIR:** Thank you. I guess just before we move on, at the end of
 8 the day it's a question of who's prepared to stump up and
 9 admit there is an issue before you even start, but thank you.
 10 Let's move on.

11 **DR SUNDAKOV:** I'm almost finished. The only thing I have left is
 12 to just answer Mr Strong's question of yesterday and he asked
 13 two questions one is, do you agree or disagree that if the
 14 Commission found that differences in the rules led to
 15 differences in the manner in which generation equipment was
 16 operated and dispatched that this should apply to the entire
 17 variable cost or value base.

18 I think the answer is "yes", if that's what the
 19 Commission found it should apply to the entire base. But it
 20 seems to me you have to be very careful under what
 21 circumstances one would find that the differences between the
 22 Crown EGB and the industry EGB could lead to differences in
 23 the manner in which generation equipment across the board was
 24 operated or switched.

25 For example, one of the suggestions was that under the
 26 Crown EGB, Transpower could exercise more influence and
 27 therefore somehow, through that influence, put more emphasis
 28 on system security. Now, one possible expression of that
 29 could be that there would be more instantaneous reserves
 30 standing by. That's not going to apply across the board,
 31 that's going to mean there's going to be one generator, or one
 32 unit of a generator standing by and perhaps being used less
 33 than it could have been otherwise, but it's not going to
 34 impact on operation across the board. So, one has to be very
 35 careful before you draw the conclusion that any differences
 36 you observe between the two would lead to the differences in
 37 the way the equipment was operated or dispatched across the
 38 board.

39 The second question is, if you were to apply to the base
 40 what should be the base, should it be the production costs or
 41 at market prices? Now, if you had a competitive market
 42 there'd be no difference. Essentially price would be a short
 43 run marginal costs and you would apply it to the same. The
 44 difference between the two arises where the market isn't
 45 perfectly competitive and it's precisely why it needs to be
 46 applied to production cost.

47 **CHAIR:** Thank you.

48 **MS CALLINAN:** Mr Chair, we just have some very brief concluding
 49 remarks set out in the two or three page note that we handed
 50 up yesterday, just to draw together the points that we've been

Transpower (cont)

1 making throughout the submission. Transpower started by
 2 identifying three key areas where the Commission will need to
 3 focus in order to determine whether this application should be
 4 authorised. They are these. The comparative advantage of
 5 industry decision-making over the counterfactual, the risk of
 6 strike down of pro-competitive rules, the risk of under-
 7 investment in the arrangement, and the alleged risk of over-
 8 investment in the counterfactual.

9 In dealing with these issues it's of course not
 10 surprising that we keep coming back to the detail of the
 11 perceived differences between how the arrangement will work
 12 and the counterfactual. Transpower has, and I hope it has been
 13 helpful to the Commission, endeavored wherever possible to
 14 provide practical examples.

15 Let's sum up where we consider the arrangement sits.
 16 Fundamentally the arrangement devolves the vast majority of
 17 decision-making to industry participants not to the industry
 18 EGB and not, in our view, to the Minister. As Bob Thomson
 19 said in his opening, under the Rulebook this transfer of
 20 responsibility to the industry EGB is to the industry EGB, but
 21 the industry EGB does not have the decision-making powers to
 22 take on the responsibility.

23 NZIER has explained why self-interested decision-making
 24 does not always equate with efficient outcomes. Professor
 25 Hogan has pointed to a number of dramatic examples of the
 26 failure of industry led decision-making in the USA. In
 27 particular in this industry there are problems arising with
 28 externalities and market power. I refer you there to the
 29 market power report that NZIER tabled yesterday.

30 Transpower has illustrated the potential for self-
 31 interested decision-making with no efficiency driver through
 32 the discussion of losses in constraint rentals.

33 The applicant's evidence of NZEM Rule changes does
 34 nothing, in our submission, to allay concerns about the risk
 35 of pro-competitive rules being delayed or blocked. The
 36 argument is that such rules are likely to be delayed longer
 37 than non-controversial rule changes. That was made clear by
 38 the graph that we tabled.

39 Transpower considers that the mechanisms in the
 40 legislation for Ministerial oversight, and in particular we
 41 wish to focus back on the Auditor-General, will not be
 42 adequate to deter and identify anti-competitive behaviour.
 43 The example we've given is financial transmission rights.
 44 Transpower says that one cannot expect the Auditor-General
 45 will attempt to oversee the industry at a level of detail
 46 where informed decisions can be made on whether this rule,
 47 among many other rules, is pro-competitive and is being
 48 delayed, and if that's delay due to the inappropriate exercise
 49 of market power.

50 We ask you to remember that the rule changes will be

Transpower (cont)

1 just one element of the very complex industry, all of which
2 the Auditor-General is being asked to review and assess, and
3 that the review is only annual and it's after the fact.

4 In Transpower's view the Act does not contemplate an
5 extensive level of qualitative oversight over the industry
6 EGB. If it did, then the resources that would be required to
7 do this properly would approximate those required in the
8 counterfactual, and this is a point that Mr Sundakov has
9 stressed in going through the benefits and detriments. If
10 this is the case, then the applicant cannot claim both the
11 benefits of self-regulation, but then deny the costs in
12 inefficiencies it says will go with heavy Government
13 involvement.

14 The other main detriment with the arrangement is the
15 risk of under-investment. Transpower has explained why it is
16 contrary to what's envisaged in the GPS. The Rulebook may
17 fail to empower the industry EGB to make final decisions on
18 investment, and in the absence of that final decision,
19 Transpower cannot be counted on to step in, as this would
20 simply not be part of its accountabilities. We reiterate what
21 Mr Thomson said, that this lack of clear accountability is a
22 major weakness in the arrangement and it will carry a heavy
23 economic cost.

24 So to the counterfactual. The counterfactual provides a
25 better balance of industry input and Government oversight in
26 our submission. The Crown EGB will be comprised of people
27 with the necessary expertise. We submit that stake-holders
28 will be represented by working groups and in relation to
29 investment decisions, the best part of Part F rules will be
30 adopted. While the Minister under the Act retains the role of
31 recommending regulations in relation to wholesale electricity
32 market and transmission, in Transpower's submission that is
33 the substantive decision-making will be at the Crown EGB level
34 with consultation with the working groups. This is reinforced
35 by the fact that the Minister is constrained in how he or she
36 deals with recommendations by the EGB. As a result Transpower
37 submits that the quality of decision-making will be comparable
38 and if not better than decisions under the industry EGB.

39 Attempts by the applicant to shift the focus away from
40 the real risks of pro-competitive rules being blocked by the
41 industry to what we say are the imagined risks of Transpower
42 pursuing anti-competitive outcomes in the counterfactual
43 should be dismissed. NZIER has explained why Transpower has
44 neither the incentive nor the opportunity to conduct itself
45 this way. Transpower has put in context for the Commission
46 the examples of rule changes that it is said to have delayed.

47 The counterfactual will deal with the problem for under-
48 investment by ensuring that the Crown EGB, or the Minister,
49 has the ability to make a final decision on investment in hard
50 cases. Transpower submits that there is no risk of over-

Transpower (cont)

1 investment under the counterfactual, given the trade-offs
2 faced by the Minister and the constraints placed on Transpower
3 by ODV and price control, and the existence of other
4 concentrated interests in the industry who are going to have
5 equal lobbying power.

6 Transaction costs of the counterfactual would not be
7 significantly different from the costs associated with the
8 multi-layered industry EGB we have before us, especially if
9 there is intended to be detailed qualitative oversight of the
10 industry EGB. Lobbying is a feature in both scenarios and
11 that's a neutral factor in our submission.

12 Assuming that there is sensible decision-making by both
13 the Crown and the industry EGB they will both seek to maximise
14 the effect of competition and service provision where they
15 can, so this factor is also neutral. NZIER has reasoned that
16 listing the cost of capital as a detriment is double counting
17 and in any event the reaction of the capital markets to the
18 regulatory outcome is unpredictable.

19 To conclude, to authorise the arrangement the Commission
20 must be satisfied that it will result, or be likely to result,
21 in public benefits which outweigh the lessening of
22 competition. In Transpower's submission on the evidence
23 before this Commission cannot be so satisfied.

24 Mr Chair, subject to any questions, that concludes
25 Transpower's submission.

26 **CHAIR:** Thank you very much on behalf of the Commission for
27 answering the questions thoroughly and certainly putting very
28 squarely how you see the situation. So, many thanks and we'll
29 adjourn till 10.30 and then it's NZEM.

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31 **Adjournment from 10.10 am to 10.30 am**
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PRESENTATION BY NZEM

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CHAIR: I think we'll reconvene. The next submitter is NZEM.
Mr Brown, please.

MR BROWN: Good morning. Ms Mallon is appearing with me and she will introduce the various people present with us this morning.

MS MALLON: To my left I have Christopher Russell, Chief Executive of M-Co, Malcolm sitting beside him, Malcolm Alexander who you know and Carl Hansen, also from M-Co, so all three to my left from M-Co, Brendan Brown and Sarah Kennedy-Good from Bell Gully to my right.

MR BROWN: We have a comparatively short submission that we want to present to you this morning. We're going to do it in three parts just to relieve any tedium that you'd have from hearing from only one person. We'll start to my left.

MR RUSSELL: Thank you. Mr Chair, Toby Stevenson, who of course is chair of the Rules Committee, would have been very keen to be here this morning to make the submission, but due to the change in times for us to present he was unable to make it. Also if I could start by saying that he would have been very keen to accommodate the changes, but I actually have a commitment this morning which means I can't be here for any more than an hour. I understand our allocated time is only half an hour anyway.

CHAIR: If you want to go beyond that obviously the Commission is just flexible. I should have just said at the outset to thank you for changing your time of appearance to suit the greater good, so I put that on record anyway, but back to you Mr Russell.

MR RUSSELL: Thank you, we're delighted to be flexible. As was mentioned I am the Chief Executive of The Marketplace Company, M-Co. The marketplace company is the market administrator of the NZEM. I am a member of the Rules Committee of NZEM and I appear here today with its mandate.

The New Zealand wholesale electricity market is a voluntary, self-regulated electricity market. It exists within a multilateral contract known as the NZEM Rules which were designed through consultation and voting by market participants.

The NZEM's governing body is the Rules Committee. It is a properly constituted democratic body. It comprises representatives of generator class market participants, purchaser class market participants, trader class market participants, the market administrator and the grid operator.

The Rules Committee is charged with ensuring the continuous improvement of the NZEM Rules, maintaining the integrity of the rules, ensuring the rules meet the needs of market participants and overseeing the NZEM Rule-making processes, including receiving working group reports and

1 recommending rule changes for market participants to vote on.

2 The Rules Committee carries out its functions in
3 accordance with the NZEM's guiding principles. Among other
4 things, those principles require NZEM to foster efficient and
5 competitive markets and to comply with the law.

6 As you are aware, the NZEM has made submissions to the
7 Commission's Draft Determination of the EGB's application and
8 in particular its price fixing analysis of the wholesale
9 electricity market. It has also maintained a watching brief
10 at this conference. It is concerned at the possibility of the
11 Commission's decision impacting on the current real time
12 operation of the wholesale electricity market.

13 Accordingly, the NZEM appears today to make further
14 submissions on this issue. The submissions are made on behalf
15 of and with the approval of the Rules Committee. As the
16 issues are legal ones, I now hand this matter over to Brendan
17 Brown QC and Jill Mallon. I understand Jill is going to start
18 off.

19 **MS MALLON:** The concern, as Christopher has said, is the risk
20 that decision number 280 will be revisited in a collateral way
21 through the Commission's decision on the current application.
22 It's understood that the Commission is not making a decision
23 on the NZEM Rules, but decision number 280 would be co-
24 laterally attacked if the Commission's finding on the present
25 application is inconsistent with decision number 280.

26 What we mean by that is that if the rationale is
27 inconsistent, then the Commission has implied that decision
28 280 is wrong and the message that conveys is that the current
29 market is a price fixing arrangement. So, that's what we mean
30 by collateral attack. We say that the Commission cannot now
31 change decision number 280, and there are a number of
32 alternative possibilities about decision number 280 which we
33 want to go through.

34 The first one is that decision number 280 was correct at
35 the time but is somehow wrong now. We say that there is no
36 room for that alternative. This is because there has been no
37 relevant change in the law in the meantime. If the Commission
38 reaches the view that there has been a relevant change of law
39 in the meantime, the Commission would need to identify when
40 and how such change occurred. For decision number 280 to have
41 been correctly decided at the time but be wrong now, there
42 would need to have been a legislative change made to
43 Section 30. There has been no such legislative change.

44 There have, of course, been subsequent cases. However,
45 case law cannot change Section 30. It can interpret it and
46 that interpretation can show that a decision that was thought
47 to be correct at the time is incorrect. Here, none of the
48 subsequent case law has impacted on the integrity of decision
49 number 280 for the reasons that we set out in our written
50 submission.

1 That submission was dated the 22nd of May 2002. In it
2 we analyse each of the three cases. They don't suggest that
3 the law has changed. They each deal with their own
4 circumstances. Those circumstances are quite different to the
5 NZEM Rules and we're not aware of any basis for any view, if
6 there is one, that they did change the law. So, that's the
7 first alternative, that it was correct then but wrong now,
8 which we say there is no room for, and I now hand it over to
9 Mr Brown for the other possibilities.

10 **MR BROWN:** It will be apparent that there are probably a variety
11 of ways that the Commission could deal with the current
12 application, a number of which might have no impact upon
13 decision 280, in which case of course my client has no
14 interest. It only has an interest to the extent that a
15 decision made on the present application could, as Jill says,
16 impact collaterally on decision 280.

17 Therefore as we see it, unless another view is put
18 forward, there are only three possibilities. Decision 280 was
19 right, but is now wrong, by reason of a change; or decision
20 280 was right, or decision 280 was wrong as it were at the
21 time.

22 The question is a question of law then for what the
23 Commission does confronted with those various scenarios.
24 That's what I want to address. I say in 10 that if the law
25 has not relevantly changed, there have been changes to the
26 statute but not in a way that impacts on the relevant
27 provisions, there are these two other scenarios. The
28 Commission considers it's right, the Commission now considers
29 it's wrong.

30 If the Commission considers that decision 208 is right,
31 then the Commission should make a determination it respect of
32 the current application, which is consistent with the basis of
33 decision 208. It doesn't mean to say it's necessarily the
34 same outcome, but I emphasise the word "consistent".

35 If the Commission, however, now considers that decision
36 280 is wrong, that is if the Commission was now sitting back
37 then, albeit the Commission is the one body throughout, the
38 position that we take, and I believe that it would be taken by
39 any, for example, a maniacus(?) addressing you, is that the
40 Commission would not be at liberty to simply proceed as if it
41 was starting afresh. To make that point we invite the
42 Commission to consider this situation.

43 The current application is not being made, but the
44 Commission, for whatever reason, has come to the view that
45 decision 280 was wrong at the time. Now, what would the
46 Commission, or what could the Commission do? Subject to the
47 powers conferred by it under the Act, when the Commission
48 reaches a decision that is *functus officio*, as is any
49 adjudicative body, such persons who have rights of appeal
50 under the Act may then exercise those rights, or review for

1 that matter. The Commission, in our submission, may not re-
2 enter upon the issue, except to the extent that the Act
3 allows, or the High Court on appeal or review directs.

4 Now, so far as the Act allowing, for example, look at in
5 respect of an authorisation granted under section 58, there is
6 power for the Commission to vary or revoke an authorisation.
7 That's in section 65. But that power is exercisable when the
8 Commission is satisfied of various matters. For example, the
9 authorisation granted on information that was false or
10 misleading in the material particular; there's been a material
11 change in circumstances since the authorisation was granted; a
12 condition upon which the authorisation was granted has not
13 been complied with. If the Commission's satisfied on any of
14 those matters, then there is a process to be followed in
15 section 65(2). But in the case of decision number 280 the
16 Commission declined to grant an authorisation because, as the
17 decision records, an authorisation was not required under the
18 Act and was therefore said to be not within the jurisdiction
19 of the Commission.

20 Now at no time since 13 September 1996, and I hasten to
21 say, and appropriately so, at no time has the Commission
22 suggested to M-Co that decision number 280 was wrong, such
23 that M-Co should, as it were, reodge the application, or
24 probably because of the difficulty of dealing with
25 authorisations in anticipation of the retrospectivity problem,
26 probably suggested to M-Co that it apply to the High Court for
27 an order for mandamus to have its original authorisation
28 determined. If the Commission had formed a view that its
29 earlier decision was wrong, it's not accepted that there's a
30 step that the Commission itself could or ought properly to
31 have taken.

32 Given that situation, we do think the Commission has to
33 ask itself with what liberty or under what constraint is the
34 Commission placed in proceeding to address the current
35 application. The current application does not open the way
36 for a collateral challenge to decision 280 we say, and we say
37 the Commission should make a determination on the current
38 application which is consistent with the interpretation of the
39 statute was applied in 280, that's leaving aside separately
40 the issue of how it --

41 **MS BATES:** Can I just ask you something Mr Brown. This is just
42 on the supposition that 280 was in fact wrong and everybody
43 was clear that the Commission had just got it wrong. Not the
44 situation that we're facing currently, but one that was
45 absolutely crystal clear. Then what do you say the situation
46 would be? That we have to apply wrong law?

47 **MR BROWN:** Well, it depends how you know its wrong. If the High
48 Court has told you it's wrong, then you then apply the law as
49 the High Court directs.

50 **MS BATES:** Well, the High Court may not have been considering

1 that particular fact situation, but one can envisage a
 2 situation where a High Court, whilst you might technically
 3 call it obiter, could say that that decision was wrong in the
 4 course of considering another case. Are you saying in that
 5 situation that we should follow our original decision even if
 6 there is High Court dicta to say it's wrong?

7 **MR BROWN:** Well, I say two things. I'm content to respond to the
 8 question on the premise that, as it were, everyone accepts
 9 that it's wrong, although it is a --

10 **MS BATES:** I'm just putting that to you to test it obviously.

11 **MR BROWN:** Quite. It is a premise that does involve, as it were,
 12 complete assurance about that. I say this, that you would at
 13 least have to consider very carefully how you address the
 14 situation, particularly with regard to a party in the position
 15 of M-Co who is working under that decision, because --

16 **MS BATES:** Under the --

17 **MR BROWN:** Under 280.

18 **MS BATES:** Yes, it doesn't need an authorisation.

19 **MR BROWN:** Yes, because as you know, the questions as to rights
 20 and wrongs and later Court saying matters are -- often Courts
 21 say later on that a decision reached many years ago was right
 22 or wrong. That normally doesn't affect the position of the
 23 parties to the decision. If you've got two neighbours
 24 fighting about a boundary fence, or a husband and wife in a
 25 matrimonial dispute, those matters are closed. This is a
 26 rather different scenario, because you have all sorts of
 27 people who are not actually parties to the process before the
 28 Commission, and in this particular situation you have an
 29 organisation that has ongoing responsibilities and actions.

30 **MS BATES:** I understand that.

31 **MR BROWN:** So, I would say this. That I can well understand the
 32 dilemma that you would see such a Commission being placed in,
 33 because no-one wants to apply law that it thinks is wrong.

34 **MS BATES:** It's a rather invidious position, isn't it, because on
 35 your -- on how you put it forward there'd be an affect on a
 36 previous decision and the rights of the parties under that
 37 decision, but if you did apply a wrong principle then of
 38 course that has certain effects for the parties before you at
 39 the present.

40 **MR BROWN:** Of course it's no different of course from any Court,
 41 even any Court in the hierarchical structure, because even if
 42 someone else says some decision is wrong, that actually
 43 doesn't give the lower Court the right to do it. Strictly
 44 speaking we know.

45 **MS BATES:** Well, the High Court can overrule its own decisions.

46 **MR BROWN:** Well, it --

47 **MS BATES:** It can.

48 **MR BROWN:** It depends in what category. There are generally
 49 accepted as being areas where it can. But it depends how
 50 particular, or how narrow the scope of the issue, and I invite

1 you to think about those decisions of, even a High Court, on
 2 the construction of documents such as a patent or a will,
 3 where because of the need for consistency and continuity I
 4 would suggest to you even a High Court does not take upon
 5 itself the entitlement to depart from an earlier
 6 interpretation, unless actually directed to by a court up the
 7 chain.

8 **MS BATES:** That is a different example than the one we've got
 9 before us Mr Brown.

10 **MR BROWN:** Well, that's a view. But -- and if you have an
 11 example before you that is different in substance from a
 12 matter previously before you, then there's the question, as to
 13 what extent a problem arises. But if --

14 **MS BATES:** I'm saying it's different to your example of
 15 interpretation of a will, that's all.

16 **MR BROWN:** Well, a will, a patent, a particularly crafted
 17 commercial transaction, they all fall, I would say, into the
 18 same category. When you've got a set of rules for the
 19 operation of a body, there is an issue as to how far away
 20 you'd move from that.

21 **MS BATES:** I follow you.

22 **MR BROWN:** I still haven't finished dealing with the response. I
 23 said to you I can well understand how any tribunal, whether it
 24 be a judge, or a Cabinet committee, or any type of
 25 organisation that confronts a situation where it says, "we're
 26 quite sure that was wrong, what do we do?" you have to act in
 27 a way that has regard to the interests of those who have acted
 28 under the earlier one as well. So, that, I'd say in this
 29 regard, you may have to consider, as I say below, applying to
 30 the Court under section 100A, the power that was given to you
 31 in one of the amendments.

32 In order for the Court to be able to instigate the
 33 process that enables, for example, an authorisation
 34 application to be reinstigated, that the problem that you've
 35 got is if you do something in one area that directly impacts
 36 on another. You not only could create difficulties for those
 37 people, but the Commission could create difficulties for
 38 itself. No doubt you would say to me that the Commission
 39 would not, shall we say, commence a proceeding against M-Co
 40 for a breach of the statute in the circumstances that you're
 41 talking about. But that wouldn't preclude possibly other
 42 persons commencing a proceeding and the Commission then could
 43 end up in that litigation as the consequent party.

44 **MS REBSTOCK:** Nothing precludes it now, isn't that correct? The
 45 fact that we declined jurisdiction wouldn't preclude someone
 46 else taking an action?

47 **MR BROWN:** Well, if an authorisation had been granted, they would
 48 be precluded.

49 **MS REBSTOCK:** Yes, I understand that. But we didn't grant one.

50 **MR BROWN:** Indeed.

1 **MS REBSTOCK:** There's nothing that stops someone now from taking
2 an action, is there?

3 **MR BROWN:** The thing that would stop them would be if the
4 authorisation was granted.

5 **MS REBSTOCK:** But it wasn't.

6 **MR BROWN:** Yes, I know that. But what could be done is for the
7 authorisation to be granted in relation to the application
8 that was lodged, and on your hypothesis erroneously
9 disallowed. Now, you may think that well we should deal with
10 that now, but the question is whether you would have
11 jurisdiction to do so. It may be that the only course would
12 be to effectively invite M-Co to apply to the High Court for
13 an order for a mandamus to require you to consider it now,
14 which would grant the authorisation, would which bring about
15 the -- it may be, of course, that no-one would commence such
16 an application. Although I would suggest to you that in terms
17 of the world of probability, the likelihood of that happening,
18 if the Commission were to say, on this application, that
19 decision 280 was wrong, that must, shall we say, enhance the
20 prospects of such a matter being pursued. There's one way of
21 obviously preventing that. That is to have an authorisation.

22 I'm explaining this because to people with a distaste
23 for litigation, shall we say, this must seem a rather
24 contorted process. But why I'm explaining it is this. These
25 are the sort of things that I would suggest that you have to
26 take into account, in terms of addressing the process by which
27 you address the problem of decision 280, if you think there's
28 a problem. That's the point I'm making. I'm not debating the
29 question of the right or wrong of 280. I say you don't get
30 into that now. Otherwise you have to consider this scenario,
31 in relation to all the decisions that the Commission has
32 reached over time, is the Commission under a constant watching
33 brief to say, "I'm not so sure about decision number X, Y, Z
34 and decision A, B, C and what do we now have to do."

35 **MS BATES:** No, really, Mr Brown, you're saying if a decision's
36 wrong we can't revisit it. I just find that fairly untenable
37 as a submission.

38 **MR BROWN:** Well, I'm not aware of the authority upon which you
39 revisit a decision that you granted.

40 **MS BATES:** I don't mean revisit that situation, that particular
41 application, but later on down the track you're saying that we
42 can't revisit and change our minds if there are reasonable
43 legal grounds for doing that.

44 **MR BROWN:** Well, it depends changing your minds about what,
45 that's the problem. That's the point. So, well, to put it
46 crisply then, I think the issue you're putting to me is this.
47 If when you come to deal with an application for a
48 determination, is there any constraint on how you deal with
49 that decision by reasons of decisions you've made in the past?

50 **CHAIR:** Yes, I think that's the nub of where you're coming from.

1 **MS BATES:** Yes, we understand that.

2 **MR BROWN:** Quite, that's all we're here to deal with and only
3 contingently, and only in respect of our interest in 280.
4 We're sort of literally the pedestrian on the crossing in that
5 sense. It may be the advice that you would be given is that
6 the manner for addressing that is wholly in process. I'm not
7 so sure. If there are differences in facts, or shall we say
8 in rules, that cause you to be able to discern points of
9 distinction between two decisions, this doesn't arise.

10 **MS BATES:** I understand that well enough.

11 **MR BROWN:** So, I'm addressing your question to me always on the
12 basis you're dealing with a *mutatis mutandis* type of
13 situation, but I am troubled by the proposition, because it
14 has been discussed in a number of cases, as of course you'll
15 be well aware, I'm sorry to belabour you with them. We say in
16 18 that, if I could take it up here, if as a consequence of
17 the Commission delivering a decision on the current
18 application, which is consistent with 280, any person or
19 persons who are dissatisfied and have standing to appeal may
20 do so, and the issue can be ventilated in the High Court.
21 It's open to the Commission to state a case to the High Court,
22 either in terms of the interpretation itself, or the process
23 to be followed.

24 But we do say it would be wrong for the Commission to
25 make a determination of the current application that
26 undermined its own decision in 280, certainly without
27 consideration of the consequences, both for the participants
28 and also for the Commission. Because even if the course was
29 adopted in good faith, well I say could result in injustice
30 for M-Co. I hasten to say, when I say "even if adopted in
31 good faith", I'm not for a moment suggesting the Commission
32 wouldn't be acting in good faith. But I was drawing on a
33 comment of then Cooke J in the *Minister of Immigration v*
34 *Daganayasi*, which is one of the cases we refer to in our
35 appendix, where he says:

36 "This does not mean of course there's been any
37 intentional unfairness. It is merely that what has been done
38 in good faith has produced an injustice."

39 That very much relates to what Ms Rebstock was saying to
40 me. You said to me, well no-one can stop them doing it now
41 and the like. If that's the case, that's the very factor that
42 I can't say be oblivious to how you deal with this, what may
43 well be something of a conundrum.

44 **MS REBSTOCK:** Is your client only adversely affected if we do not
45 authorise the application before us? Because if we do
46 authorise it, M-Co basically ceases to -- it gets absorbed
47 into the wider scheme, would that be correct?

48 **MR BROWN:** Well, the answer -- it won't surprise you coming from
49 me, the answer is susceptible of a yes or no.

50 **MS BATES:** The answer is what? Pardon, I didn't quite catch you.

- 1 **MR BROWN:** The answer isn't susceptible of a yes or no, but I
2 would say this.
- 3 **MS REBSTOCK:** Some day you will surprise us Mr Brown.
- 4 **MR BROWN:** No, it doesn't. I say that because it might depend
5 how you dealt with the authorisation. I'm assuming that your
6 question involves this, that you have determined that an
7 authorisation is required, that you have jurisdiction to grant
8 it, and therefore also that the tests are met. It sill, I
9 would submit, it still may give rise to consequential issues
10 as to what might have to be done with the original
11 application.
- 12 **MS REBSTOCK:** Can you explain that to me, what those issues might
13 be?
- 14 **MR BROWN:** Well, I can, although I'd rather not put thoughts in
15 people's minds. But shall I put it this way, you would have
16 one trade practice authorised, there would be another trade
17 practice unauthorised and depending upon the extent of
18 correlation between them, I can see room for issues arising.
19 I'll elaborate still further if you wish.
- 20 **MS REBSTOCK:** No, I understand the point.
- 21 **CHAIR:** Just before you move on, the fact that jurisdiction
22 wasn't claimed for 280 so therefore there was no need seen for
23 authorisation at the time, presumably that in practise was
24 something of a disincentive for parties to take that further.
- 25 **MR BROWN:** I don't think there would have been a scope for an
26 appeal.
- 27 **CHAIR:** No.
- 28 **MR BROWN:** As I read it, certainly not by the person who declined
29 it. When one declines jurisdiction to act, for the reason
30 that the Act mandates certain state of affairs in order for an
31 authorisation; when one declines jurisdiction, the normal
32 course for someone to satisfy it is to go to the High Court to
33 seek an order in the nature of mandamus requiring them to stop
34 refusing to do things and to do them.
- 35 **CHAIR:** But the fact that a jurisdiction wasn't seen as
36 appropriate, presumably people who may have wished to
37 challenge NZEM per se at the time would have seen in the
38 Commission's decision then less reason for being able to
39 sustain such a challenge.
- 40 **MR BROWN:** Quite.
- 41 **CHAIR:** So, your second point now is if we decide it needs
42 authorisation, it needs to be authorised in order for you to
43 stop that development if nothing else. Yeah, okay.
- 44 **MR BROWN:** There's a point of fact that should be made clear, in
45 order it doesn't lose anything in the translation, could
46 Mr Alexander.
- 47 **CHAIR:** Yes, please, Malcolm.
- 48 **MR ALEXANDER:** It's just responding to something Commissioner
49 Rebstock indicated in terms of I think the words were
50 "absorption of M-Co within the new arrangements". The

1 absorption or not in terms of a commercial impact on M-Co as a
2 company is something that M-Co has lived with this since the
3 day the Caygill inquiry reported frankly. That's not why
4 we're here. We're here on behalf of the Rules Committee of
5 the NZEM because we have a real time market with market
6 participants trading, they have been doing so since October
7 1996, with service providers providing services into it on the
8 basis of decision 280, that is why we're here, so it's
9 material to the M-Co issue.

10 **MS REBSTOCK:** I understand that, I do. I understand the concern
11 that you have currently with the position that's stated in the
12 draft. I'm very clear on that.

13 **MR ALEXANDER:** I just wanted to be clear, it's not an M-Co
14 thing, it's a market issue.

15 **CHAIR:** No I think that's what -- point well made, nonetheless,
16 thanks for confirming that. Mr Brown.

17 **MR BROWN:** Can I say, I've thought a lot about the very point you
18 asked me at the beginning of this. Do you say that if someone
19 has said X it can't change its mind. Well, we're familiar
20 with the doctrine of precedent and res judicata and the like.
21 But they're a complex body of rules and I don't profess to
22 know the accurate answer, but I do say --

23 **MS BATES:** Neither do I.

24 **MR BROWN:** No, but I do say that, and indeed if we weren't here,
25 no-one would be likely to raise the point on our behalf. It
26 may be that to the extent there's a problem, and I suggest
27 there certainly is a problem, it may be able to be addressed
28 in a process way. Although I'd be surprised if that can be
29 addressed in a process way without the intervention, in some
30 way, of a High Court process because of the strictures of the
31 Act in terms of anticipatory authorisations and those sorts of
32 issues.

33 I don't know whether you've counsel assisting or how
34 you're going to address that, but there is clearly an issue.
35 The issue will not manifest itself if you, as it were, decide
36 this application in a way consistent with 280. If you don't,
37 the issue arises. We -- when I say I'd be overstating -- when
38 I say we wish to be helpful, we wish to be helpful to us, we
39 wish to be helpful to you as well, and it's no good leaving
40 this matter to surface after the event.

41 **MS BATES:** We understand quite clearly that following 280 is the
42 easier route, and we haven't made up our minds on the
43 substantive issue on the price fixing, but we do understand it
44 would be the least complicated route, but thank you, we do
45 appreciate you drawing to our attention any difficulties we
46 may face.

47 **MR BROWN:** Well, I'm not pressing on you any position in relation
48 to the current application, because that's not my brief. I
49 wouldn't want to be thought to be therefore, if I were
50 pressing it, to press it on you because it's the easiest way,

1 although -- no, I don't take that any further.

2 Now, we have annexed to our submission, purely for
3 assistance to indicate some of the background, we thought it
4 might be of particular interest to you the authorities we're
5 referring to, obviously *HTV v Price Commission*, there's a
6 significance on this issue and it's been -- the Commission
7 will be familiar with the *Northern Roller Milling* case. I
8 don't think it's productive to go off into those areas in this
9 discussion because you clearly understand the point and we're
10 happy to answer any questions you may have about it.

11 **MS REBSTOCK:** Just while we have you there, I'll just ask you one
12 further question. I mean it does occur to me that while the
13 rules are quite similar, the fact situation around them isn't
14 entirely the same. There are changes under this proposal that
15 may, may, and I put that purely in a theoretical sense, may
16 change the view on whether this is a price fixing issue. Just
17 as a for instance, the fact that you will have one market and
18 one market only if the proposal goes ahead, whereas under the
19 current arrangement you have some competition with it. So, it
20 does seem to me that there's even a question about whether the
21 fact situation is the same and whether the fact situation
22 itself may not lead to a different answer. So, it would be
23 useful if you could comment on that.

24 **MR BROWN:** Well, I do hope you won't think I'm being unhelpful,
25 but I don't think it would be appropriate for me, for NZEM, to
26 be commenting on the applicant's application. I understand
27 the point you're making to me about are there differences, but
28 I would, with respect, suggest that it should be the applicant
29 that's given the opportunity.

30 **MS REBSTOCK:** What I'm saying to you is there is a possibility
31 that we're not actually -- you could imagine a situation, and
32 I'm not saying that it's here, you could imagine a situation
33 where we wouldn't actually be saying 280 was wrong, but the
34 circumstances here are different and because of the difference
35 in the fact circumstances in terms of the surrounding
36 components of this proposal, that we come to a different view
37 on whether the section applies or not, and whether we have
38 jurisdiction. In that case I wonder if your arguments hold,
39 that's what I'm asking you to comment on.

40 **MR BROWN:** Well yes, I can comment on that because our submission
41 has been carefully framed throughout to talk about any
42 decision that you would make that would be, as it were,
43 inconsistent with 280. That is challenging its basis. What
44 you're putting to me is if you were reaching a decision that
45 relied, for the basis of that decision, on, as it were,
46 principles or whatever, that sort of thing. That's different
47 again from what we're saying.

48 **MS REBSTOCK:** I'm not saying the case Mr Brown.

49 **MR BROWN:** Of course.

50 **MS REBSTOCK:** I just wanted to explore that with you because we

1 won't have the chance following this to do it.

2 **MR BROWN:** It does follow that to the extent -- can I put it this
3 way, to the extent, if this were a different case, a different
4 case, then the implications to which we've been responding
5 perhaps would not arise. But I would not want to respond to
6 it, and I don't think you're asking me to respond to issues of
7 difference, degrees of difference, or even materiality of
8 difference, which is interestingly one of the tests in section
9 65.

10 **MS REBSTOCK:** No, I'm not, I'm just noting really that issue may
11 be sitting there.

12 **MR BROWN:** We're conscious.

13 **MS REBSTOCK:** That this is quite a different application to the
14 one we looked at in 280. Even if some of the rules within it
15 are similar.

16 **CHAIR:** Thanks very much and we'll certainly take full account of
17 your submission and one or two of the suggestions that arose
18 from it. Thank you very much.

19 Shall we take three minutes break while the applicant
20 lines up for the final reply. So, we'll start about 14
21 minutes past 11.

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23 **Adjournment from 11.10 am to 11.15 am**

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RIGHT OF REPLY BY EGBL

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CHAIR: All right we'll resume. Mr Kos please.

MR KOS: Thank you Mr Chairman, members of the Commission. We've reached the point of reply. I'm very grateful it occurs in this week and not next. I do not think we will need to take the Commission past lunch today. What we have set out in the folder in front of you called "notes of reply" is some quite extensive material and can I say, as I mentioned to members of the Commission yesterday, that is intended primarily for use by the Commission and its staff and we don't intend to go through it cover to cover. What is on there, and you'll find at the end of the folder loose, is a single page which is headed up "summary". I wonder if you could keep that readily at hand, because in fact our entire reply today will drive off that document, and from time-to-time we'll dip into the reply, the more detailed material, but otherwise we intend to stick pretty much to that document.

Can I say also that notwithstanding the practice of this Commission in relation to how it conducts replies, we apply no principle of *res judicata* for consistency to you in relation to that. We would be very happy to address questions and we're in your hands, Mr Chairman, as to how you'd like that dealt with, whether we deal with questions perhaps at the end of each bullet pointed section, or simply take them as they come, it's simply a matter for the Commission and we'll endeavour to answer them of course.

CHAIR: All right, I think if you start off anyway we can probably pick any questions up under sections. The only point I'd make, if you do have to respond it's really a question of whether we would seek any further comment from others, it would have to depend on the substance of them. So, I suggest start and we can pick up questions if we need to. But one assumes that you'll be looking to answer a number of the points that were made anyway, so it might be just questions of amplification rather than substantive debate. Anyway over to you please.

MR KOS: Thank you. At an earlier stage this document had a different title, this one page and I lost the vote as to what it was called, but it used to be called "the battle ground" and in a sense that page does cover the battle ground because those are the essential issues in common with Transpower which is the primary posing submitter on that point because it covers the same issues that Ms Callinan traversed in her closing.

But although this is the battle ground there is some important common ground and before we tackle the document I'd just like to touch on three important points of common ground that seem to have emerged in the course of the conference.

The first is the identity of the counterfactual and how

EGBL Right of Reply

1 the Commission should deal with that counterfactual. I've
2 referred to this again in more detail in the notes of reply,
3 in section 1. I just touch briefly at page 4 of the detailed
4 notes. All I want to take the Commission to is paragraph 1.1
5 where we say that; by the end of the conference the correct
6 approach appeared more or less to be a matter of consensus.
7 The Commission's role was to identify the most likely state of
8 the market should the proposal not proceed. The
9 counterfactual is, therefore, that identified in the Draft
10 Determination, a Crown EGB constituted under part 15 of the
11 Act, and that it would have a Rulebook of its own
12 substantially in accord with the Rulebook under the proposed
13 arrangement, and I've referred there to some of the evidence
14 in the course of the hearing. So, that's the first important
15 point of common ground.

16 The second is that by-in-large there is a consensus that
17 the industry EGB model is preferable to a Crown EGB model.
18 That is not simply something endorsed by Parliament, by
19 Government and the majority of members of the industry that
20 have appeared before the Commission in the course of this
21 conference, but also notably by consumers. That was the
22 preferred position of both the Major Energy Users Group and
23 CC 93.

24 So, at the end of the day, of the submitters who are
25 die-hards for the Crown EGB they number two, by my count. One
26 is Transpower and the other, so far as one can discern it, but
27 I think one can discern it, Comalco. So, that's the second
28 point of common ground.

29 The third is that there seems to be a strong consensus
30 that the innovation presented by Part F of the Rulebook has
31 been official and we have Transpower on board on that point as
32 well with us. It is the really new feature of this particular
33 proposal and it facilitates multilateral contractual
34 investment and is seen clearly by Transpower, as it is by the
35 applicant proposing it, to be beneficial. So, those are the
36 three points of common ground I thought was useful to touch on
37 before we tackle the battle ground.

38 I appreciate I keep avoiding starting on the battle
39 ground, but it's probably useful to finish on that topic, the
40 analysis of benefits and detriment. So there are one or two,
41 in fact four short topics that I wouldn't mind touching on
42 which are of general application first.

43 The four I'd like to touch on are these; price fixing
44 which we've just heard NZEM on, secondly the scope of the
45 application, thirdly guidelines, and fourthly conditions. I
46 want to be very brief on these because they are touched on in
47 detail in the notes of reply.

48 So, if we just start with Section 30, we find that
49 addressed in the notes of reply at page 6 section 2. Can I
50 say that we have taken a slightly different approach from the

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1 one that was presented by NZEM. We're not different in spirit
2 from the position they're advancing. But rather than advance
3 arguments based on consistency, we have presented an argument
4 based directly on the merits of the proposal, and the question
5 as to whether or not this particular proposal involves an
6 infringement of Section 30 at all. I'll ask James Palmer just
7 to touch on this in a moment.

8 But what the Commission will see in section 2 page 6,
9 particularly at paragraph 2.5, we have looked at the wholesale
10 pricing mechanism, for instance, of the Rulebook, have
11 submitted that it involves finding not fixing of price, and
12 that while the mechanism finds a spot price, it can be traded
13 at any price and we have addressed each -- going on to the
14 next page -- addressed each of the points raised by MEUG in
15 its submissions which suggested that in fact there was an
16 institutionally price distorting effect of the proposal.
17 James.

18 **MR PALMER:** The submissions in relation to the wholesale pricing
19 mechanism have been traversed and re-traversed a number of
20 times, so I don't propose to go into any detail into our
21 fundamental decision that decision 280 was correctly decided
22 and that the law has not been changed in any relevant respect
23 by subsequent cases. However I would like to touch on two
24 points.

25 The first is that it's important to see the context of
26 the price determined by the wholesale pricing mechanism. It's
27 a spot dispatch price which is generated from the supply
28 schedule which is determined by generator offers and purchaser
29 bids, and that determines the spot price, but electricity can
30 still be traded at any price that two parties agree. That's
31 done by way of a contract for differences, and the differences
32 relative to the spot price are paid by the parties, so in a
33 sense its an a netting off, but electricity can still be
34 traded at any price. That relates to a suggestion aired by
35 Commissioner Rebstock with NZEM whether this arrangement was
36 different to the NZEM arrangement in the sense that it lacked
37 the ability, or bilateral trades were not possible. So, far
38 as its relevant to Section 30, the parties can still trade
39 outside the arrangement, they can agree any price they like.
40 So we would submit that there's no relevant difference between
41 the arrangements.

42 The only other point I wanted to touch on relates to the
43 consequences of a finding by the Commission along the lines
44 suggested as a possible finding in the Draft Determination.
45 We submit that any ruling broad enough to capture the
46 wholesale pricing mechanism, any ruling which captures an
47 influence on price in an agreement between competitors would
48 also capture a large number of other arrangements. Business
49 to business exchanges that are set up where competitors come
50 together to form a marketplace would be caught as well as I

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1 would submit auctions, and tender processes. Although in that
 2 case the direct contractual relationship may be bilateral
 3 between the person offering the tender, or the auction house
 4 and each of the people bidding at the auction separately,
 5 there may be a sequence of bilateral arrangements. Given the
 6 relatively low threshold for finding of an understanding under
 7 Section 30, it's entirely plausible that there does exist an
 8 understanding between all the participants in a tender or an
 9 auction, in which case those processes would be caught by a
 10 broad interpretation of Section 30. The relevance of that, is
 11 as to whether or not that could have possibly been an
 12 interpretation intended by Parliament.

13 In relation to cost sharing and the pricing methodology,
 14 we simply submit that those relate to services which are
 15 collectively acquired in relation to cost sharing. It's
 16 things like the system operator role which is collectively
 17 acquired throughout the Electricity Governance Board on behalf
 18 of all the participants and paid for jointly by them.
 19 Therefore section 33 applies, similarly in relation to the
 20 transmission pricing methodology, although the Rulebook is
 21 only a process for confirming a pricing methodology. The
 22 ultimate pricing methodology divides the cost of a
 23 transmission service. The transmission service itself is a
 24 common service and is collectively acquired. We therefore
 25 submit that Section 33 applies to both cost sharing under the
 26 Rulebook and pricing methodology, but again they are not
 27 caught by Section 30. Cost sharing is common between
 28 competitors, is a common practice which can be efficient and
 29 it's submitted it is not intended by Parliament for that to be
 30 per se illegal under Section 30. I'd happily take any
 31 questions, but those are our submission on those issues.

32 **CHAIR:** That's fine, thanks Dr Palmer.

33 **MR KOS:** The second general or procedural topic is found at page
 34 45 of the notes and concerns the scope of the organisation and
 35 its expansion and again I'll ask Dr Palmer to address that.

36 **MR PALMER:** There are really two issues here. First ancillary
 37 provisions and secondly the extension of the application to
 38 cover voting arrangements. In relation to ancillary
 39 provisions, the applicant has requested that any authorisation
 40 cover provisions which give effect to the explicitly set-out
 41 primary and secondary provisions under each of the seven
 42 categories that we've identified. We feel that that is within
 43 the Commission's power to use the reference to ancillary
 44 provisions in order to sure up an authorisation if it decides
 45 to grant one.

46 There's nothing in the Act which prevents an
 47 authorisation of a set of provisions which are referred to by
 48 description rather than being set out expressly. There's no
 49 limit in the Act, we submit, to your jurisdiction to do that.
 50 If the Commission was to take a different view and was not

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1 inclined to use the ancillary provisions description, we would
2 simply request that if it was possible for any authorisation
3 to be worded to similar effect, that as well as the expressly
4 referred to provisions, any provisions which gave effect to
5 those in an incidental sense would also be covered. That
6 would just give a bit of certainty to any authorisation which
7 was granted.

8 In relation to voting arrangements, the applicant seeks
9 an extension of its authorisation request to cover the set-out
10 provisions in relation to voting. It is submitted this is a
11 technical request given the content of the Draft Determination
12 which focused very much on voting arrangements, that all the
13 parties and participants in this process have had ample
14 opportunity to raise any views or concerns in relation to such
15 an extension.

16 **MR KOS:** That's our submission on that topic Mr Chairman.

17 **CHAIR:** Thank you. Please.

18 **MR KOS:** The next one is very brief which is found at page 47,
19 topic 15, the amendment process. That concerns the
20 applicant's request to the Commission for some guidelines as
21 to future amendment. James, that's one you're covering as
22 well, I think.

23 **MR PALMER:** This is a request from the applicant that it believes
24 is in the industry's interest to have as much certainty as
25 possible as to guidelines which should be followed as the
26 Rulebook evolves over time. It is not, as Transpower has
27 submitted, a simple paraphrase of section 65. Section 65 when
28 it comes to rule changes provides very little guidance. The
29 test which is set out is the applicant's interpretation of a
30 couple of decisions, one Australian, one New Zealand, in
31 relation to section 65 and the Australian equivalent. If the
32 Commission is of like mind that that is a correct
33 interpretation of those decisions then it would assist the
34 industry if that could be confirmed in some way.

35 **CHAIR:** Thank you.

36 **MR KOS:** The fourth and last topic at this level is the
37 imposition of conditions. That's dealt with at page 50, topic
38 17. Without the benefit of any authority whatsoever, because
39 there is none, that's material anyway, we have set out there
40 what we think is the proper analysis as a matter of law as to
41 the circumstances in which the Commission can impose
42 conditions. The Commission will see that we have identified
43 two categories.

44 The first we've called at 17.3 "necessary conditions".
45 We say that subject to the other category, conditions should
46 only be imposed to the extent necessary to ensure that the
47 public benefits exceed the public detriments of the proposal.
48 In other words they serve to tip the balance.

49 There's a second category, though, which we have to
50 acknowledge. That is that there may be a situation where,

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1 notwithstanding a conclusion that the benefits outweigh the
2 detriments, the Commission because of, I think the expression
3 the Trojan horse, or perhaps the Trojan clause was used
4 earlier on, and because of this Trojan beast the Commission
5 concluded that notwithstanding that the benefits outweigh the
6 detriments it should nonetheless refuse the exercise of its
7 discretion.

8 What we've suggested there is this category of
9 discretionary condition where the Commission might still
10 impose conditions to remove, to remediate or mitigate the
11 objectionable features, the Trojan thing, which presented an
12 obstacle to authorisation. We've talked there about
13 procedure. I don't need to go back into that. We submit that
14 the conditions that we have proposed are the former, the
15 necessary kind, to tip the balance. We make this point at
16 17.6, that is, we say, the applicant does not agree with the
17 underlying premise in the Draft Determination that might make
18 either necessary, but if the Commission remains unmoved on
19 that, then we present them.

20 Can I say also just two more things. We have dealt at
21 some length, and I'm not going to take the Commission through
22 it at this point but simply leave the record in front of the
23 Commission, with the three conditions advanced, or traversed
24 by Meridian, and so they appear over the next two to three
25 pages. I want to ask Dr Hansen to comment on some
26 observations made this morning by Transpower in relation to
27 the second potential condition relating to exemption.

28 **MR HANSEN:** Thank you. Transpower gave a number of examples as
29 to why it thought the extension of the existing exemptions
30 relating to Part G to cover potentially the whole of Part G
31 and Part H ought not to be considered. The examples given,
32 though, are actually already covered by -- at least some of
33 them are already covered by the exemptions. Transpower talked
34 about the need for a single set of mandatory rules for
35 dispatch and so on. But actually if you look at the Rulebook,
36 the exemption provision that is currently in the rules covers
37 bids and offers and schedule and dispatch. So, the extension
38 that is in condition 2 is to items such as pricing and
39 clearing and settlement, not issues really that Transpower
40 have referred to this morning. I guess just the concluding
41 comment on that, to the extent that some rules do need to be
42 mandatory, then presumably the board would take that into
43 account in its decision.

44 **MR KOS:** That's all we want to say, Mr Chairman, in relation to
45 general or procedural matters.

46 **CHAIR:** All right thank you.

47 **MR KOS:** So we now turn to the summary, and its division between
48 detriments and benefits and the analysis of those. The way we
49 propose to approach this is that I will essentially lead the
50 discussion on the left-hand side of the ledger and David

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1 Caygill will lead it on the right-hand side. In each case we
 2 will be assisted by our colleagues at the table. Can I just
 3 note also that when you look through it you'll see small
 4 parenthetic statements, for instance the first one appears
 5 under the first bullet point. Six out of ten delays resulted
 6 from Transpower, this is 5.31. Those are cross-references to
 7 the reply, so those are the -- that's a cross-referencing
 8 through to the main document.

9 We start then with the first of two principal
 10 detriments, potential detriments identified in relation to the
 11 proposed arrangement. We start by looking at the graph that
 12 Transpower presented, which on the face of things, was a
 13 visually unappealing account of the proposal. But that graph
 14 invites some closer analysis. We provide this in the notes of
 15 reply at page 26 under issue 9 paragraph 5.31. The point we
 16 make, going on to page 27, is that when we look at those ten
 17 contentious areas that were traversed in the graph, we can see
 18 that the working group and the Rules Committee processes have
 19 worked appropriately, even though some of those issues have
 20 remained contentious and have been considered several times.

21 **MS BATES:** Where are you?

22 **MR KOS:** Page 27. 5.3.2.

23 **MS BATES:** Sorry.

24 **CHAIR:** Please, Mr Kos.

25 **MR KOS:** I'm moving on now to 5.3.3. I'll ask Dr Hansen to
 26 comment on this point because he has done the analysis. But
 27 when one does that analysis and we are providing to the
 28 committee a copy of the working group and the Rules Committee
 29 minutes, which I'm sure will be much appreciated by the
 30 Commission staff, but we've been a bit more helpful than that.
 31 We've provided some pretty clear cross-referencing to the
 32 decisions. What one finds in the six of the ten cases you
 33 will see that in fact Transpower was a very significant
 34 delaying factor in relation to those issues, so again one has
 35 to looked a look a bit past the headlines into what in fact
 36 the process was. So, can you comment on that please Eric?

37 **MR HANSEN:** Yes, if you refer back to the Murray and Hansen paper
 38 of May 2002, in that annex 2 we had a listing of each of the
 39 issues and bullet points. Each of the particular bullet
 40 points can be found in the minutes and papers that we would
 41 like to hand over to the Commission just so you can perhaps
 42 get a broader context of where those come from.

43 I'd particularly like also though to respond to a claim
 44 by Transpower in the last few days regarding the two hour rule
 45 and the claim was, or the submission was that Transpower had
 46 this year made an offer to NZEM to drop the two hour rule, or
 47 reduce it for demand side for the bids but not for the offer.
 48 We are unable, and NZEM is unable, to locate any paper that
 49 makes that offer. We have located what we believe is the most
 50 recent paper from Transpower dated 1 February this year, which

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1 goes through these issues and ends up with the conclusion and
2 the recommendation that there be no dispensation for the
3 demand side. So, we're unable to corroborate that and just
4 wish to point out that perhaps -- we note the person from
5 Transpower, who would have attended those meetings actually
6 has not been present at this conference, is overseas, so there
7 may be just a mistake on what the facts were.

8 **MR KOS:** This is covered in the reply at paragraphs 5.3.4 to
9 5.3.6.

10 **CHAIR:** I think the last sentence in 5.3.5 is the specific point
11 you've just made.

12 **MR KOS:** Correct. That's the first point of distinction, just to
13 say look past please the headlines of the graph. But secondly
14 the next bullet point we go to in the summary, is that of
15 course these particular decisions have been undertaken under a
16 completely different governance structure from the one that is
17 proposed in the arrangement. So, it's one thing to look at
18 the way in which matters have proceeded hitherto, it's another
19 then to consider what will happen after the proposed
20 arrangement is implemented if you authorise it.

21 A good example perhaps of that is to look at the reply
22 at paragraph 5.2.2 which concerns the vexed question of the
23 late development of FTRs. Picking the analysis up at 5.2.3,
24 we submit that the delay before FTR development began is
25 unambiguously the responsibility of Transpower, but that as to
26 the delays since developments in May 2001 at 5.2.4 we note
27 that that's been conducted outside of any established
28 governance forum where decision rights are allocated
29 appropriately.

30 So, we submit that the difficulties and delays
31 experienced and given voice to in evidence at this conference
32 by Transpower are not relevant evidence of the likely
33 difficulties to foster pro-competitive elements under the
34 Rulebook and we note that to be consistent with the Ministry
35 of Economic Development's latest statement that suggests that
36 governance of FTRs be shifted from Transpower to an industry
37 arrangement.

38 **CHAIR:** I think there was the acknowledgment by Transpower at one
39 point that some of the FTR discussions surrounded the nature
40 of the product rather than the competitive elements or not of
41 it.

42 **MR KOS:** Yes, that's certainly one factor. When the Commission
43 looks, though, at the structure provided for in the Rulebook,
44 particularly in Part A section 4, and this is now familiar to
45 the Commission no doubt, you see the powers of the EGB in
46 relation to working groups and they're quite invasive powers.
47 The setting of agendas, prioritising of rule change proposals,
48 the appointment of working groups, the ability to set up an
49 alternative working group if the first one hasn't dealt with
50 the matter properly, the ability in fact to sack a working

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1 group if matters have not progressed adequately. Then allied
2 to that then is the possibility also presented in terms of the
3 first condition that the applicant has advanced which would
4 enable a second rate and even an appeal to the rulings panel.
5 So there is a rigorous process set out in the Rulebook which
6 simply doesn't exist in relation to the way in which FTRs, for
7 instance, have develop. Is there anything you want to add to
8 that?

9 **MR CAYGILL:** I don't think so.

10 **MR KOS:** I will ask Mr Caygill though --

11 **CHAIR:** Just a question again, I don't want to interrupt you all
12 the time, but it's the same point you made a minute back, that
13 under the proposal the processes under which things like FTRs
14 will be developed are quite different with different
15 incentives and different outcomes, that's the point you're
16 making.

17 **MR KOS:** That's correct, there is in fact a governance structure
18 to work to.

19 **MR CAYGILL:** Perhaps one point is worth making about FTRs, apart
20 from the obvious point is that it's a fiendishly complicated
21 subject, lots of people understandably struggle with it. I
22 think it might also be said that to some extent, some parts of
23 the industry at least have simply felt that it is a subject
24 which ought to be considered in the context of the new
25 Rulebook. In other words what I'm saying is, I think to some
26 extent the fact that a new Rulebook has been in the process of
27 development, requiring to be authorised and so forth, has to
28 some extent contributed to the difficulty in getting closure
29 on the subject of FTRs. I wouldn't want to explain all the
30 delay on that basis, but I believe that that has made a
31 contribution.

32 **CHAIR:** So you're saying that some parties felt the new Rulebook
33 process would better enable it to be addressed, is that your
34 point?

35 **MR CAYGILL:** Yes, I believe they felt that. But there's also
36 simply the point that lots of things have been going on over
37 the last couple of years and I'm constantly amazed by how much
38 resource people can give to different working parties, but to
39 some extent people have simply said let's get a new Rulebook
40 in place first and then it will be appropriate to pick up the
41 subject of FTRs.

42 **CHAIR:** I see your point, thank you. Mr Kos.

43 **MR KOS:** I'll ask Mr Kos to continue with the third point which
44 is the comparison made with the PJM market.

45 **MR CAYGILL:** As I understand Transpower's argument in particular,
46 they've essentially been saying there is a risk that an
47 industry organisation will frustrate pro-competitive rule
48 changes or innovations, and they've sought to illustrate that
49 risk by a comparison with PJM and pointed to PJM as having
50 developed FTRs, for example, which clearly hasn't happened yet

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1 in our market. I'd like to make two points.

2 The first is I don't for a moment suggest that it's an
3 unfair comparison, but it occurs to me to observe that PJM was
4 held out to the inquiry as the best of the American regional
5 markets. I think it's a comparison that we should tolerate,
6 but we should recognise that it's been not unreasonably chosen
7 by Transpower, but they're pointing to what FERC has
8 recommended to visitors as the best market to go and have a
9 look at.

10 If you do look at PJM, however, and we've set out the
11 detailed response I wanted to make on page 22; the fact is
12 that while PJM might be thought to be ahead of the New Zealand
13 market in having developed FTRs, there are a number of other
14 developments, innovations, that have occurred in the
15 New Zealand market and are not present in PJM or indeed other
16 parts of the United States. PJM does not price losses. There
17 may be reasons of size or scale relevance in their system
18 compared to ours. I think there are very strong reasons why
19 the New Zealand system needs to price losses. But the fact is
20 we do and they don't. Their market might be thought to be
21 less efficient for that.

22 PJM, and indeed much of the United States, does not yet
23 have retail competition at the household level. That's
24 typically as I understand it regulated by individual States.
25 So, possibly not within the purview of a regional market like
26 PJM, but it's an innovation in our market not present there.
27 I think more significantly perhaps than either of those two
28 examples, the New Zealand market has got to the point where
29 rules have been developed that will allow quality and security
30 standards to be set collectively. That certainly doesn't
31 exist in the PJM market, or anywhere else that I am aware of.

32 I recall the occasion when the inquiry was meeting with
33 some experts at Berkeley being complemented on the fact that
34 New Zealand had got to the point, or was even embarking on the
35 discussion that would allow quality and security standards to
36 be set collectively. That certainly doesn't happen in PJM.
37 We have more market mechanisms in relation to reserves than
38 does PJM. Then the final example that we've been talking
39 about for much of the last week in relation to Part F. Like
40 common quality, there's no decision-making mechanism
41 equivalent to that in PJM, nor, as far as I'm aware, is it
42 even under discussion.

43 So, I would suggest that FTRs goes one way, but the
44 general comparative point that Transpower make, we suggest, is
45 not valid. There's no reason to think that industry rules of
46 the kind we've had or we envisage frustrate innovative
47 developments.

48 **CHAIR:** Thank you.

49 **MR KOS:** The fourth point then we make is, and we'll make it in
50 more detail later, I'll just touch on it at this point, is

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1 that Transpower has itself supported self-interested party
2 decision-making. We see that particularly with their support
3 and indeed they were the applicant in relation to MACQS and
4 we've set out at paragraph 4.3.3 of the notes, which is at
5 page 16. Their application, I'll just touch on a couple of --
6 if one looks quickly through that passage there, we see in the
7 second paragraph of it, at the bottom of page 16, Transpower
8 believing that increasingly it would not have the information
9 necessary to make well-informed decisions. Repeats their
10 comment in about line 5. At about line 6 or 7, grid users are
11 more aware of their own interests. Later on about the middle
12 of that paragraph, grid users are in a better position to
13 evaluate the costs and benefits of different levels of
14 quality. At the end of that paragraph, the proposals will
15 create an opportunity and provide the incentives for grid
16 users, Transpower and providers of ancillary services to
17 search for innovative solutions. In short, in the next
18 paragraph they say the objectives of the proposed arrangements
19 are to ensure that decisions reside with those who have the
20 best information and incentives relevant to the decision and
21 to ensure that the decision-makers are accountable under
22 contract for their decisions. Amen to that from us.

23 We'll come back to the Commission's decision on MACQS,
24 but both that and their support of Part R indicate that their
25 position has been, at prior points anyway, support for, as I
26 put it, self-interested party decision-making. There has
27 been, with respect to that particular party, something of a
28 wobble both in its treatment of that philosophical issue and
29 also in its treatment between its original submissions and its
30 presentation at this conference of the distinction between the
31 two models. There was a great deal of argument over the last
32 four days trying to conflate or bring together the two models
33 and say how similar they were, which is I think at some
34 contradistinction to the early position. I'm not being
35 critical, it's simply what happened.

36 So, that's the fourth point. We'll come back to it
37 because it's a common theme that pops up in a number of other
38 places during this part of the reply.

39 The fifth point we note, and I'll ask David Caygill to
40 address it in a moment, is that there are continuing effective
41 checks and balances under the proposal to ensure that you do
42 not get the strike down by the industry of pro-competitive
43 rule changes under this proposal. Can I say, just in
44 introducing that point, that there has been a significant mis-
45 characterisation of, particularly the legislation, in relation
46 to the checks and balances it provides. We've had
47 suggestions, for instance, that the auditor is a kind of
48 under-resourced empty vessel and experienced in reviewing
49 performance standards, which I suggest to you is in all
50 respects incorrect. It's also been suggested to this

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1 Commission that the Minister will be unable to intervene until
2 there have been two negative audit reports. One has only to
3 read the legislation to see that the Minister can intervene at
4 any stage without any audit report. So, certainly that
5 premise is entirely misconceived. That by way of
6 introduction, David.

7 **MR CAYGILL:** You can see the summary of the list of elements here
8 and there's been a lot of discussion about them. We've
9 repeated them, or elaborated slightly on them, at page 15,
10 para 426. I don't need, I think, to spend a lot of time on
11 this. The Governance Board is independent. It has the
12 capacity to promote rule changes. It's entitled to advance
13 rule changes all of its own motion. It has the responsibility
14 for ensuring that working groups perform. It sets them up, it
15 gives them their terms of reference, it appoints people to
16 them, it will hold them to account. The Minister has a clear
17 rule and reference has been made to the legislative framework
18 in which the Minister can operate.

19 One can see, I think, and we argued this right at the
20 outset, that in some ways the legislation is almost modeled on
21 present practice, or present practice is already foreshadowing
22 how the legislation might work. In the process of reporting
23 regularly to the Minister, the Establishment Committee has
24 found itself invited to take up new subjects. There have been
25 discussions around timeframe. The Minister has expected
26 regular reporting. That reporting has been public and the
27 result has been that issues like bid and offers, or the
28 disclosure of bids and offers, is now the subject of a rule
29 change in front of the Commission with a fall-back rule.
30 Hydro spill itself may not be an example so much of an
31 innovation which will promote competition, but it is an
32 example of an issue put on the industry's agenda by the
33 Minister to which the industry has responded. So it's an
34 example of the kinds of processes that we're talking about at
35 work.

36 The rulings panel, the Rulebook envisages is clearly
37 very like the Market Surveillance Committee jurisdiction, not
38 precisely the same but broadly similar. Like the Market
39 Surveillance Committee one would expect it to be wholly
40 independent, and it has a jurisdictional oversight role in a
41 number of ways under the proposed Rulebook. None of these
42 arrangements in any way alter the wider law. The Commerce Act
43 will still apply, giving jurisdiction to the Commission, but
44 also the capacity for third parties to take issue with actions
45 if they believe there's any instance of anti-competitive
46 behaviour.

47 Finally it seems to us one shouldn't ignore the capacity
48 for individual parties to blow the whistle, either publicly or
49 by approaching the Minister. One has seen in this process,
50 and I think evidenced in the submissions that have been made

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1 to this Commission, plenty of interest and capacity on the
2 behalf of consumer groups representing small and large
3 consumers, the resource that Transpower puts into vigilating
4 on issues, there's no reason to expect that that will diminish
5 under the Rulebook.

6 In sum, we simply say that there is a plethora of checks
7 and balances of mechanisms which should give the Commission
8 confidence that there is no significant risk that competitive
9 innovation will be frustrated under the Rulebook and in this
10 regard no difference in detriment compared to the
11 counterfactual.

12 **CHAIR:** Thank you.

13 **MR KOS:** That serves as a summary, perfect summary thank you,
14 conclusion to that section. I was going to say exactly the
15 same thing. So, efficiently we'll proceed now to the next
16 topic of under-investment.

17 Can I indicate at the beginning of this topic that it's
18 in under this heading, Mr Chairman members of the Commission,
19 we propose to deal with the questions raised this morning by
20 Commissioner Rebstock in relation to emergency situations.

21 Now, Transpower have already said the question here, in
22 relation to under-investment is and has been one of, not one
23 of security but of constraints. The question then becomes in
24 terms of the difference between the two models, whether there
25 is an adequate back stop. We submit that this is effectively
26 a non-issue. I think it's necessary to take the Commission
27 through what we say on this in a little bit more detail than
28 we have on the previous topic. If I could take you to page 31
29 and topic 7. I'll go fairly closely through what we have said
30 there.

31 What we submit in paragraph 7.1 is that under-investment
32 will not occur because the proposal addresses the current
33 reasons for under-investment without removing Transpower's
34 back-up role. The key point being without removing that role.
35 Now, as we say in the next paragraph there appears to be
36 common ground that transmission investments of are two types.
37 In relation to security investment by Transpower has been
38 generally accepted to be adequate. But the problems have
39 arisen in relation to constraint removal because Transpower
40 has lacked the ability to form binding conditions and
41 coalitions to pay for the investment.

42 In terms of the counterfactual there's been general
43 acceptance that Part F would be there, except though the Crown
44 EGB would be able to force investments to be paid for by the
45 industry if it thought a worthwhile investment had been turned
46 down under Part F. So, I think we need to look and see what
47 Part F actually does. That's what we do in the next section.
48 We summarise it quite crisply here.

49 It supplements the existing process of transmission
50 investments, it does not replace the existing processes.

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1 Section 1 of Part F clarifies service definitions, measures
2 and levels currently being provided by Transpower. Section 2
3 contains a binding coalition forming process, for two things.
4 For changes to existing service levels and for the
5 introduction of new services and there is the provision for
6 the allocation of votes to those who pay for the services, for
7 those new and changed service levels. Then part 3 sets out a
8 process for confirming transmission pricing methodologies
9 which serves the purpose of dividing the cost of collectively
10 acquired transmission services, it's an allocative function.

11 But the important point we next make is at E,
12 transmission services are not provided under Part F, they're
13 provided under separate bilateral arrangements between the
14 transmission provider and each customer. The participants
15 under Part F will be bound to implement some results, for
16 instance service change proposals which had received a 75%
17 majority. But importantly, Part F does not remove
18 Transpower's investment obligations under its Statement of
19 Corporate Intent and under side letters.

20 **CHAIR:** Can I just interrupt, Commissioner Curtin has to leave
21 for another appointment, so it's not a question of not wishing
22 to be here while it's concluded, so he'll just leave now.

23 **MR CURTIN:** My apologies.

24 **MR KOS:** Not at all sir, it's all in writing. So, what we have
25 summarised in 7.5 is that what Part F attempts to do is to
26 overcome historical impediments for contracting transmission
27 services, a lack of clarity as to the service being provided
28 and hold-out problems. But under Part F the sale and purchase
29 of transmission services remains on a bilateral basis and
30 Transpower's investment role is not altered by the proposed
31 Rulebook.

32 We then submit in 7.6 that the proposed arrangement will
33 not lead to under-investment. It's important to look at the
34 limited way in which the proposal changes Transpower's
35 existing role. First of all, most of the investments
36 discussed at the conference are investments required to
37 maintain existing service levels. Transpower can make and
38 earn a return on such investments under its existing bilateral
39 arrangements. Part F will facilitate the process by providing
40 clear service levels and pricing methodologies. We've talked
41 there about the ODV process as well. We conclude that
42 paragraph by saying that, for these types of investment
43 there's no difference between the proposed arrangement and the
44 counterfactual.

45 Where, secondly, an investment provides a new service,
46 section 2 of Part F provides a process for coalition
47 formation. It's an optional process for transmission
48 providers to follow. For example, investments involving just
49 the transmission provider and a single purchaser will not need
50 to go through the process at all, but for investments

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1 impacting on multiple parties, section 2 of Part F addresses
2 hold-out problems. It does that also of course through
3 section 3, which provides for pricing methodologies. When you
4 have a defined and accepted pricing methodology, the
5 probability is that hold-out is diminished when you have the
6 quantum meruit case where you have an established market value
7 for services provided. So, it helps in that way as well.

8 So we submit that there are no convincing reasons given
9 as to why this process would fail to create coalitions for
10 investments with a net benefit and for which a potential
11 coalition would therefore exist. Indeed Transpower seem to
12 have much the same view on those two points.

13 But the third point is that if, contrary to our
14 submission, some efficient investments do not occur under
15 existing bilateral arrangements, or through a coalition for
16 new services, this alone represents a difference between the
17 arrangement and the counterfactual in relation to under-
18 investment.

19 That is where Transpower argues that a back-stop role is
20 important. But of course Transpower currently fulfills that
21 role and the point we make is that Part F doesn't change that
22 role. It can continue to make investments necessary for
23 security and recover its return as it does currently. In our
24 submission therefore the difference between the proposal and
25 the counterfactual will not be significant.

26 Transpower then resorted to the GPS, which is said it
27 mandated a shift from the status quo. In our submission,
28 there's no basis for that. It has no relevant legal effect.
29 It does not override Transpower's Statement of Corporate
30 Intent, nor section 5(3) of the SOE Act which requires
31 compliance with the SCI. In our submission there's no reason
32 to think that Transpower's role will change between the status
33 quo and the proposed arrangement.

34 The fourth point we make is that for a Crown EGB to
35 recommend and a Minister to approve efficient investments, it
36 has to gain sufficient information to interpret customer
37 preferences and the trade-offs inherent in those preferences
38 and to determine a price, quality and method of delivery that
39 meets the demands of transmission customers and that suppliers
40 are able to provide. The transaction costs, in our
41 submission, of obtaining accurate information sufficient for
42 efficient decisions are likely to be high. In other words,
43 what we are submitting is that industry based decision-making
44 regarding constraints is still likely to be better and that
45 there will be less moral hazard than the counterfactual with
46 forced investment by a central planner.

47 So, that's essentially the submission. Our submission
48 is that, taking the third bullet point, the industry
49 arrangements provide a better back-stop where the decision-
50 makers bear the cost, the decision-makers have better

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1 information and the current back-stop role of Transpower is
 2 retained. So, that's the submission in relation to that
 3 particular point in relation to whether there is a real risk
 4 of under-investment as between the counterfactual and the
 5 proposed arrangement.

6 Is there anything you want to add to that submission?

7 **MR PALMER:** I just reiterate the current position is that
 8 Transpower makes its investment decisions both through
 9 agreement and in a back-stop role. Those are paid for on a
 10 bilateral basis, it recovers its revenue requirement. That
 11 picture doesn't change under the Rulebook, the Rulebook is
 12 purely supplementary, it helps clarify what the service is
 13 which helps for contracting. It has a pricing methodology
 14 confirmed through a process in the Rulebook, but it doesn't
 15 change the underlying method of payment which is bilateral
 16 arrangements, nor does it change Transpower's back-stop role.

17 **MR HANSEN:** Can I just add one comment to that. I think some of
 18 the examples discussed in the last few days where Transpower
 19 has had difficulty forming coalitions are under quite a
 20 different structure. Again it's a different governance
 21 structure. This is a structure where binding coalitions are
 22 formed. The big problem, as Transpower's identified in its
 23 Auckland examples and so on, is where you're trying to get
 24 participants to vote or agree on a pricing structure. Of
 25 course that's just a purely allocational distributional issue.
 26 That is unlikely to be successful. What this arrangement does
 27 is take that out of the hands of, or it enables the parties
 28 that join, to pre-commit to take that out of their own hands,
 29 so that it's determined by the provider and the board, not by
 30 the purchasers. I think that's quite an important difference
 31 that will increase quite substantially the possibility of
 32 successful decisions.

33 **MR PALMER:** So, if you look at the set of efficient investments
 34 in transmission which should be made, a very large proportion
 35 of those are investments to maintain existing service levels.
 36 They are conducted under the existing bilateral arrangements.
 37 Transpower can go ahead and do that. What remains are new
 38 services or changes to service levels. Section 2 of Part F
 39 provides a coalition forming process. Its optional. The
 40 transmission provider, whether it's Transpower or someone
 41 else, doesn't having to through that if they can come up with
 42 a bilateral agreement with someone or can form a coalition
 43 outside it. It's an optional arrangement which provides a
 44 rational, efficient basis for forming coalitions and should
 45 get rid of any under-investment that's existed in the past.

46 To the extent that there's anything left in this set of
 47 efficient investments, the Transpower back-stop role is
 48 present, as it is now, in the proposed arrangement which is
 49 equivalent in terms of under-investment to the counterfactual.

50 **CHAIR:** Thank you.

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1 **MR KOS:** So that the difference, James, correct me if I'm wrong,
 2 is that you have a slightly different back-stop under the
 3 counterfactual where a Minister might direct an investment to
 4 occur which had failed to be approved on the way through,
 5 either by bilateral or multilateral process. On that matter
 6 the question then becomes well who is the better evaluator of
 7 the appropriateness of that investment. Is it an under-
 8 investment at all? If in fact it's failed to achieve traction
 9 on the way through the process provided for in the Rulebook
 10 under either model.

11 **MR TAYLOR:** Just to explore a bit further for clarification, a
 12 number of times Mr Thomson made the point that, at least I
 13 interpreted his point as, that under-investment in efficient
 14 transmission would over time leave lead to a security issue.
 15 Could you just react to that particular question in the
 16 context of the discussion we're having here?

17 **MR CAYGILL:** Can I make perhaps a preliminary point. I think
 18 that statement's perfectly reasonable and wouldn't have any
 19 quarrel with it at all. But I think the kind of time period
 20 that is involved is a matter of years rather than months, or
 21 weeks or what-have-you. One of the processes envisaged in the
 22 Rulebook -- there was some discussion about this a couple of
 23 days back I recollect -- is that Transpower as the system
 24 operator, or the system operator whoever that might be, will
 25 be obliged each year to produce an annual statement of the
 26 state of the assets, if you like, the state of the grid; to
 27 identify the potential security risks as well as the
 28 constraints, to give the industry an opportunity to respond to
 29 that. It ties in with Part F, though not necessarily
 30 directly.

31 In fact that process has been -- that kind of document
 32 has been produced twice now I think. Transpower showed the
 33 second example, I'm not sure that that's actually yet been
 34 published, but it's certainly been printed. So, it's an
 35 accurate statement in and of itself, but the fact is that one
 36 wouldn't get to that consequence unless lots of other things
 37 failed to happen, including ultimately Transpower itself
 38 declining to continue to act, as they have indicated they have
 39 acted in the past, of ultimately being prepared to make
 40 investments necessary to ensure system stability. Our point
 41 is not that they have -- it's wrong of them to say that's how
 42 they've acted. Our point is, it's entirely open to them to
 43 continue to act that way.

44 **MR TAYLOR:** Continue to act that way, yes, I understand.

45 **MR CAYGILL:** However, the rules provide a number of
 46 opportunities, much more clearly than is the case at the
 47 moment, for others to come in at an earlier stage and reduce
 48 the likelihood that Transpower would need to act in that way.

49 **MR PALMER:** So, while a constraint exists and there's a
 50 possibility of an efficient investment being made which

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1 reduces it, a coalition should form. If it doesn't, and it
2 becomes a security risk, then Transpower should act.

3 **MS BATES:** I think what I understood Transpower's point to be is
4 that its back-stop role was really more security orientated.
5 I think you'd accept that, and that whilst it will act as a
6 back-stop in that way, it's not necessarily if it's just
7 acting as back-stop, going to be producing optimal decisions
8 for the industry, or for the public benefit as a whole.

9 **MR CAYGILL:** Well, perhaps if I can just venture a comment.
10 What's optimal is not intuitively obvious, is a matter of much
11 debate. I'm not arguing for a moment Transpower's view's
12 necessarily going to be wrong, but what I do argue is that a
13 Rulebook that allows the appropriateness of particular
14 investments to be considered to be challenged, allows
15 coalitions to form, able to enter into binding contractual
16 relationships. All of that machinery which does not exist at
17 the moment, will help ensure that we are more likely to get
18 optimal investment than a regime where only one party has the
19 capacity to act unilaterally on the basis of what it believes
20 is optimal. But, nobody else's view of optimal can prevail
21 because of the lack of a machinery which will enable binding
22 contractual arrangements to be given effect to.

23 **CHAIR:** I think Part F got a fair bit of support for those
24 reasons, as I understood the submissions made. But just to
25 add to that, the point made this morning by Transpower that I
26 think it was said a Minister rang up and said a transformer's
27 failed somewhere, fix it or there'll be an inquiry, that
28 position doesn't really alter as I understand your submission.
29 It's up to the Government if they want to have somebody as the
30 Minister to fix it as last resort independent of the Rulebook.

31 **MR KOS:** And in that situation Transpower has no difficulty in
32 recovering the cost of that investment, because it's
33 essentially a maintenance of security, system security
34 expenditure. The difficulty comes in relation to larger
35 investments such as constraint investments where it's not
36 prepared to hazard the investment because the difficulty
37 contractually or in terms of the ODV methodology to recover
38 that investment.

39 **CHAIR:** I think there was an acknowledgment that the Part F
40 process, at least in principle, was aimed at addressing that.

41 **MR KOS:** That's right. That carries through of course to both
42 models, both the counterfactual and the proposed arrangement,
43 because it seems to be accepted Part F would be in both. The
44 question then comes to this residual back-stop at the end of
45 that process under either model where a proposed investment
46 has failed and the question becomes whether you should then
47 have a Government directing that additional investment, not
48 the one that Commissioner Bates is talking about.

49 **MR TAYLOR:** In essence the SCI still says there is your
50 submission.

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1 **MR KOS:** Correct.

2 **MR TAYLOR:** Which is the back-stop. I understand the point.

3 **MS BATES:** Can we come back to the other situation for minute, I
4 just want to clarify in my mind, where one can envisage a
5 situation where constraints ought to be removed from the grid,
6 it is not yet a security problem, but the industry players,
7 the other industry players will not necessarily have a
8 financial benefit in voting in favour of it.

9 **MR PALMER:** They will.

10 **MS BATES:** I mean you can envisage that a situation like that
11 could occur.

12 **MR PALMER:** When a constraint exists it will be reflected in high
13 nodal prices in the area which is constraint. It's an
14 efficient investment, if the cost of the investment is less
15 than the high nodal prices which result, so there's a net
16 benefit which is available to the people who are the people
17 who will pay for the investment. So, if it's efficient to
18 invest, reduce the nodal prices, then that's the coalition
19 which will form to make the investment. That's why Transpower
20 supports Part F on that reasoning, that when there's a net
21 benefit, the market should work. It hasn't worked in the past
22 because of the hold-out free ride problems, but those are
23 addressed in section 2 Part F.

24 **MS BATES:** Well, I suppose -- I'm sorry to push this, but just
25 so I'm being clear -- if the nodal price is higher, would it
26 not possibly be in the short-term benefit of the generator or
27 retailer -- gentailer to keep the high prices?

28 **MR KOS:** The answer I think is no. But Dr Hansen can say why.

29 **MR HANSEN:** Perhaps by -- the answer is no. I'll follow him up.
30 Perhaps by way of example, suppose we have this constraint in
31 the central North Island binding. What does that mean? It
32 means that prices will be higher in Auckland, that's the
33 direction of flow, that generators south of the constraint in
34 the South Island will be receiving low prices. If the
35 constraint was removed those generators in the South Island
36 would be able to deliver more of their product to Auckland and
37 receive that price advantage.

38 So, in that example, certainly generators operating in
39 Auckland are benefitting from the higher nodal price, but
40 those in the South Island are disadvantaged. The way we look
41 at it is the binding, forming of binding coalitions, the
42 incentive is on Transpower, or whoever is the transmission
43 provider, the service provider, to identify those that are
44 going to benefit. Because otherwise they're at risk of
45 getting the proposal voted down. So, in that example, the
46 incentive very clearly would be to say well, it's the
47 generators in the South Island that are benefitting from this,
48 maybe some other people as well, you certainly wouldn't
49 include the generators operating in Auckland in there because
50 they're going to lose from it.

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1 So, it's this process through the pricing, setting of
2 the pricing and having that agreed with the board, but not
3 with the purchasers because they've always got an interest to
4 shift it to someone else. That's why the pricing process is
5 taken out of that, the pricing structure. So, the
6 transmission provider has the incentive to identify the
7 providers who will benefit, the pricing structure gets agreed
8 with the board and then the votes are allocated on that basis.

9 So, in that example it would be the South Island
10 generators, for example, that would have a large share of the
11 votes, or the relevant distributor, and then their decision is
12 vote yes or no. They don't have, you know, the Auckland
13 example that was discussed the other day is quite clear,
14 Transpower are quite clear they considered ten different
15 possible solutions. Everybody came to a clear decision on
16 what was the best solution. It fell over at the point when
17 they were arguing about who was going to pay what share of the
18 costs.

19 This process takes that decision out -- the purchasers
20 are agreeing, are committing by signing this contract to take
21 it out of their hands and for it to be decided by someone
22 else. That's what causes a lot of these decisions to fall
23 over, we believe so. Then once the structure is determined
24 it's a simple yes or no vote. If you're a beneficiary,
25 presumably you'll vote in favour if you've got a net benefit.

26 **MR KOS:** I'll ask David Caygill to follow.

27 **MR CAYGILL:** Mr Chairman, I think, with great respect, the
28 Commission needs to be pretty careful about this subject of
29 constraints. With respect, I think one of the really
30 important things to acknowledge is that constraints don't bind
31 all the time. A constraint may occur because of an outage, a
32 particular piece of plant is taken out of the system for some
33 maintenance and that produces a constraint on the particular
34 line for a period of time. Maybe only half an hour, or half a
35 day.

36 The question then arises is it sensible to invest in
37 some more transmission, or indeed some more generation,
38 because of that occasional risk that a constraint occurs and
39 the price of energy for that period of time is higher. In
40 other words there's a balance, there's no right or wrong
41 answer, there's no black or white answer to this. I chaired a
42 meeting yesterday of the Grid Security Committee which looked
43 at the latest information on constraints this year. It is
44 clear that the single biggest constraint at the moment is in
45 relation to the Bay of Plenty area. So far this year the Bay
46 of Plenty has been constrained between Whakamaru and Atiamuri
47 for 14 percent of the time.

48 Now, a number of consumers and interest in the Bay of
49 Plenty are very concerned about that and are clearly talking
50 about what they should do; reduce demand, increase local

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1 generation, invest in transmission. Just as last year a
2 similar discussion occurred the central North Island
3 constraints which are now bound anywhere near as much this
4 year because, I think essentially Transpower undertook some
5 investment.

6 Now, the difference is that under the new Rulebook there
7 are some rules that will arguably make it easier for people to
8 reach transmission investment decisions, nothing to stop
9 people making generation investment decisions in the past, or
10 demand reduction decisions in the past, but now they'll have
11 some rules that can also allow them to make transmission
12 investment decisions.

13 If I might revert briefly to a question you asked,
14 Mr Chairman, the example of a Minister saying, "some
15 transformers have failed this isn't good enough I want that
16 fixed", is a useful, I don't doubt real example, because it
17 helps to identify the difference between a security issue and
18 a constraint issue. If a transformer has failed, then almost
19 certainly an asset owner, the owner of the transformer, is no
20 longer complying with their security requirements.

21 One of the distinguishing features of this Rulebook
22 compared to what we have at the moment is that there actually
23 are quality performance obligations on asset owners, including
24 Transpower. So, in future, the Minister shouldn't need to
25 say, "a transformer has failed and I want something done about
26 it", the Rulebook will require that people comply at all times
27 with performance obligations. If they don't the Rulebook
28 provides for penalties, which are enforceable through the
29 contractual mechanism.

30 The Rulebook should cover security requirements in a way
31 that has not been the case under the existing market because
32 it has no functionality in that area. The Rulebook will not
33 mandate, will not require anybody to address constraint issues
34 because that is for the market to decide, well, you know, are
35 we better off accepting a higher energy price temporarily, or
36 is a transmission solution the right answer, or a generation
37 solution? It is not obvious that just because there's a
38 constraint on a particular line for a particular period of
39 time, anything necessarily should be done about it. It might
40 be that the most efficient outcome for the country as a whole
41 is to pay briefly a higher energy price.

42 **CHAIR:** I think without reopening the whole argument, there would
43 seem to be from submissions made, you're aware of them as well
44 as the Commission, an acknowledgment that the Part F process
45 was going the right way to get some of these, for want of a
46 better definition, constraint or capacity investment decisions
47 made. What you're saying now is that leaving aside whether or
48 not the incentives in the Rulebook to have quality levels
49 sustainable at certain levels, assuming notwithstanding that
50 something goes wrong, I think what I'm hearing is nothing in

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1 the Rulebook stops Transpower, or anybody else, being
2 nominated by the Government to fix it.

3 **MR CAYGILL:** On the contrary. The Rulebook requires that a
4 number of parties perform in certain ways that they are not
5 contractually obliged to behave in at the moment.

6 **CHAIR:** It's to fill that gap I'm thinking about. All right.
7 Thank you. Mr Kos.

8 **MR KOS:** That leads us on then neatly to the last point which is
9 not written down, which is the emergency situation, which we'd
10 just like to tackle briefly. What I'd like to say about that
11 is three things. David Caygill has just really tackled the
12 first of them, which is to say that the way in which the
13 Rulebook, under either model, would mandate an investment, a
14 particular investment being made is because of a failure to
15 meet a performance quality standard.

16 So, to that extent if you have an emergency situation,
17 critical failure or some equipment or something, you can see
18 that both models of the same Rulebook would produce the same
19 mandated requirement. So, I think we're looking here for
20 differences between models in terms of the net benefit
21 detriment analysis. There isn't a difference in relation to
22 the mandating of the investment.

23 The question I think is the second point which is, to
24 what extent to the processes or differences in processes
25 between the two models retard a reaction or a response to that
26 emergency? That leads me to the third point which is what I'd
27 like to do is take Commissioners to the Rulebook and show them
28 how the Rulebook actually addresses that situation and the
29 emergency powers it actually expressly confers, which weren't
30 averted to this morning. I'm not sure if the Rulebook's
31 there.

32 It's dealt with in Part A section 5 paragraph 3 and that
33 appears at page 60 of the Rulebook, Part A of the Rulebook.
34 It's called a "regime for dealing with undesirable
35 situations".

36 "An undesirable situation is any contingency or event
37 which threatens or may threaten trading on the market where
38 the consequences would be likely to preclude the maintenance
39 of orderly trading and proper settlement of trades and so
40 forth."

41 There are two particularly important provisions I draw
42 the Commission's attention to. Paragraph 3.3.

43 "The board may act if directed by a regulatory
44 authority. In the event that any regulatory authority has
45 given a direction to the board in respect of an undesirable
46 situation, the board may take whatever steps it considers
47 necessary to enable compliance."

48 That links in then with the provisions that Commissioner
49 Bates drew our attention to this morning, in particular 172.G
50 which provided for the making of regulations without the full-

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1 blown consultation process that the Act would otherwise
2 require which could be used in an emergency situation.

3 So, what would happen would be that a Minister could,
4 consistent with the Rulebook and the statute, pass a
5 regulation or trigger a regulation to take effect which gave a
6 regulatory authority, and I don't know what form that will be
7 because that will depend on the regulations, the power to
8 direct the board. The board then has the contractual right,
9 under the Rulebook, to do whatever's necessary to react to
10 that situation.

11 **MS BATES:** We did have a brief look, after that discussion, at
12 that undesirable situation rule and I don't say we've been
13 able to look at it in any detail, but it would seem that the
14 definition of "undesirable situation" relates to a situation
15 precipitated by something in the rules.

16 **MR KOS:** I don't think so.

17 **MR CAYGILL:** I don't think that's --

18 **MS BATES:** It's where the consequences of strict enforcement of
19 the rules would or would be likely to -- it seems to be
20 something aimed at a problem with the market rather than a
21 physical problem.

22 **MR CAYGILL:** I think it's -- can I make two points. I think
23 firstly this is not novel to this Rulebook, similar rules
24 exist in NZEM. Secondly, I agree that 3.2 speaks of a
25 consequence to the market, but I thought your first suggestion
26 was that it depended on a cause originating in the rules or
27 the market and I would assert that that's not the case, that
28 the cause could easily be external.

29 **MR KOS:** I think what, with respect, Commissioner, you've done is
30 to leap to the second part of the rule and the first part is
31 the important bit. "Any contingency or event which threatens
32 or may threaten trading", that's the undesirable situation
33 where strict application of the rules would be likely to
34 preclude the maintenance of orderly trading.

35 **MS BATES:** Is that another situation are you saying?

36 **MR KOS:** No, what I'm saying is --

37 **MS BATES:** Sorry, just take me through it slowly.

38 **MR KOS:** The undesirable situation is the event which threatens
39 trading, but that's okay if the rules as they are strictly
40 complied don't cause a problem. But if the rules strictly
41 complied do cause a problem then you have what's called an
42 undesirable situation and that then triggers the emergency
43 powers that exist in 3.3 and 3.4. I was about to -- well, I
44 think that's how I see it, I think that's how we both
45 interpret it.

46 **MR CAYGILL:** It's been written precisely because in a physical
47 market, it may well be that something outside the market
48 impacts on the market's capacity to continue under those
49 rules.

50 **MS BATES:** I'm sorry to be slow, but I'm just having difficulty

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1 with the meaning of that second part where the consequences of
2 strict enforcement of the rules would or would be likely to
3 preclude the maintenance of orderly trading. What's it in
4 there for are you saying, why is that bit in there?

5 **MR KOS:** That's there because it's saying that -- if the
6 emergency can be dealt with without affecting orderly trading
7 within the existing Rulebook framework then you carry on, you
8 don't have an undesirable situation. But if strict
9 application of the rules would cause that disruption, then you
10 have an undesirable situation. You don't need to escalate it
11 to that status.

12 **MS BATES:** So you've got a --

13 **MR KOS:** Unless you need to go outside the rules.

14 **MS BATES:** You've got an undesirable situation and let's say it's
15 something to do with transmission, and it's going to threaten
16 the market because physically the market can't operate because
17 there's nothing being transmitted, right. Then you've got, so
18 I can understand it up to it may threaten trading on any
19 market. Then it's just how the next bit operates that I'm not
20 quite sure of, how it actually fits into that scheme. Why do
21 you have to have it there?

22 **MR CAYGILL:** The strict enforcement of the rules --

23 **MS BATES:** Where the consequences of strict enforcement of the
24 rules would or would be likely to preclude the maintenance of
25 orderly trading, why is that in there?

26 **MR CAYGILL:** The rules won't work any longer, for the moment, as
27 a consequence of whatever's happened.

28 **MS BATES:** Are you saying -- I just suggest that if that's the
29 purpose of it that it's rather odd drafting.

30 **MR CAYGILL:** Well, quite a bit of the drafting probably needs to
31 be reviewed in the fullness of time.

32 **MS BATES:** Do you understand what I'm saying?

33 **MR KOS:** Yes, I do. I think what it's saying is you don't need
34 to escalate it into the special category which then creates
35 all sorts of consequences. You can still have an orderly
36 market within the framework of the rules.

37 **CHAIR:** Just a practical one to get back to that Bay of Plenty
38 transformer, I accept your point Mr Caygill that the quality
39 standards that are part of the contracting arrangements ought
40 to prevail. The point I think that you made this morning, if
41 that does not, then in essence does that part of the Rulebook
42 you've just quoted trigger it to be fixed?

43 **MR CAYGILL:** I think the failure of an individual transformer
44 would --

45 **CHAIR:** That was just a case in point.

46 **MR CAYGILL:** No, I think it's a useful example, because I think
47 the answer is that we're probably a long way from the
48 application of this rule in terms of scale. The failure of an
49 individual transformer might well affect the capacity on a
50 particular line. The system operator will then give a

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1 security notice in relation to that line under other powers,
 2 and so certain things would happen in a particular region.
 3 3.2 is really designed to address a situation where the scale
 4 of the contingency is so large that -- to use the terminology
 5 of the engineers, you know, it's when you're into -- your N
 6 minus 2 has been triggered, you've had one piece of equipment
 7 go down, you're now to N minus 1, another piece of equipment
 8 has gone down, and --

9 **CHAIR:** It's just the way it was portrayed this morning, if I'm
 10 not putting words into Transpower's mouth as it were, was that
 11 the proposal would inhibit that sort of response, in essence,
 12 taking place.

13 **MR CAYGILL:** We do not accept that at all. We do not see any
 14 difference in capacity, in the way the rules function, under
 15 the Rulebook compared to the present time. 3.2 has a precise
 16 equivalent in the existing NZEM Rules. There is no lack of
 17 capacity to deal with crisis situations that we can identify
 18 or would acknowledge.

19 **CHAIR:** That was the crux of the point made this morning.

20 **MR CAYGILL:** We have an industry Rulebook governance at the
 21 moment. There are many differences, but they don't relate to
 22 the capacity of the market to respond in a crisis. That isn't
 23 different, the Rulebook you have in front of you compared to
 24 the present contractual arrangements. Transpower have not
 25 drawn anyone's attention to an incapacity in the Rulebook as
 26 drafted in relation to crisis situations. That's a wholly
 27 novel submission, they're entitled to make it, I'm just saying
 28 to you that's not a matter of design that's ever been in
 29 contention.

30 As I understand the submission, and I wasn't here this
 31 morning when they made it, I gather they were contrasting the
 32 counterfactual with the Rulebook, while I would challenge that
 33 comparison because it must equally be a comparison between the
 34 counterfactual and the status quo, and there has not been any
 35 argument, that I'm aware of, that either under the status quo
 36 or the draft Rulebook there is some deficiency in respect of
 37 how one would be able to respond in a crisis situation.

38 **CHAIR:** That point was made this morning and I just wanted to get
 39 your response to it.

40 **MR CAYGILL:** Apart from 3.2, the system operator is able to act
 41 in an emergency and ignore requirements just on them. The
 42 Rulebook provides that they negotiate what's called a policy
 43 statement. It's a non-technical -- non-contractual
 44 explanation for the market of how they will honour their
 45 performance obligations. In an emergency situation they are
 46 entitled to set the policy statement aside and say, I'm sorry
 47 normally we do X and Y and Z, but today right now we can't.
 48 The Rulebook provides that they can do what needs to be done
 49 as system operator.

50 **MR KOS:** You'll find that in part C page 63, pages and pages of

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1 exciting emergency type stuff in what's called technical code
2 B, emergencies.

3 **MS BATES:** I don't want to unnecessarily belabour this point, and
4 I'm sorry to do so, but when you do come back to look at rule
5 3.2 and you look at rule 3.2.1, 2.2, 2.3, 2.4, all of those
6 are trading related matters and not crisis management matters.
7 I do --

8 **MR KOS:** One has to read the opening words to that, "without
9 affecting the generality of the foregoing an undesirable
10 situation includes", so I take your point but no-one's going
11 to be sort of pointy lawyers about this in an emergency, I
12 suggest, to you. So, we point be having a debate about --
13 when we're standing around a failed transformer.

14 **MS REBSTOCK:** I realise Mr Caygill wasn't here for the earlier
15 discussion, but the discussion was in the context of
16 addressing whether dual accountability, mixed accountabilities
17 in a governance structure causes difficulty in a crisis
18 situation, and I just want to make it clear, Transpower did
19 not put this submission to us, they responded to a question on
20 the spot.

21 So, to be fair to them I think it's important to say,
22 they did not put a late submission to us. I know you weren't
23 here, so it was in that context of the proposal seems -- it
24 has been suggested that the proposal involves a bit of a
25 blurred accountability by the industry, whether it is
26 accountable to the industry or it is accountable to the public
27 interest through the Crown. It was in that context that we
28 asked the question and it had a lot of discussion about past
29 crises and in the case of Mercury and others, there have been
30 discussions over time about whether mixed accountabilities led
31 to a Parliament in terms of timing of response. It was in
32 that context. I think, Mr Caygill, to put that in context it
33 might be --

34 **MR CAYGILL:** Thank you for that. That does help me indeed
35 understand both what happened and the nature of the argument.
36 I'm familiar with Transpower's view that these arrangements
37 have elements of dual accountability, and simply stated our
38 response is that that is not a deficiency of the proposed
39 arrangements. There are roles assigned to the Minister by the
40 law, they provide -- and you know.

41 **MS BATES:** I do accept the legislative framework, under both the
42 proposal and the counterfactual, allows the Minister to step
43 in in difficult situations and they're pretty parallel.

44 **MR KOS:** I think the point we're trying to make, I'm sorry I
45 wasn't suggesting you're being a pointy lawyer, but rather
46 simply, that what the Rulebook provides for is wide-ranging
47 powers both in the section we've drawn attention to and later
48 on, which means there isn't a retardation of response created
49 by this Rulebook over a situation that would arise under the
50 counterfactual.

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1 **CHAIR:** No, I think you certainly answered my concern, My
2 Caygill, on that one. We'll have a look at part C obviously
3 as well which was the part that was put by Mr Kos.

4 **MR PALMER:** The final point on that though is that 3.2.4, the
5 situation referred to there is much broader than the heading
6 might suggest. It covers any exceptional or unforeseen
7 circumstance which is at variance with, or which threatens, or
8 may threaten not just just and equitable principles of
9 trading, but the public interest as well. So, any form of
10 unforeseen circumstances affecting public interest.

11 **MS BATES:** I just make a point that I think it would be better to
12 have a rule directed at crisis management.

13 **MR KOS:** That's probably where we need to look at C, the pages
14 and pages.

15 **CHAIR:** You mentioned part C.

16 **MR KOS:** So that's, Mr Chairman members of the Commission, what
17 we wanted to say on the detriments side of the ledger.

18 **CHAIR:** I think it was useful having a discussion because it was
19 quite a significant issue that was discussed this morning.
20 Okay, back to you.

21 **MR KOS:** The conclusion we advance, therefore, to the Commission
22 after all that, is that when one looks at the detriment
23 analysis against the counterfactual, neither heading, the
24 strike down of pro-competitive rules or the prospect of under-
25 investment are indeed material or, in our submission, in fact
26 existent at all as risks. So, that that's our submission in
27 relation to the detriment side of the ledger, and David, I'll
28 leave to you lead off on benefits.

29 **MR CAYGILL:** I don't need to elaborate I think on much of this.
30 It covers ground that you'll be familiar with. I think we're
31 really trying simply to summarise the perspective we hold
32 having listened to all that's been said to the Commission. We
33 assert to you still that one of the principal benefits that
34 the new Rulebook presents is that it will lead to better
35 decision-making than the counterfactual Crown EGB.

36 The first point which we believe has not been
37 successfully challenged is that that is the view of Parliament
38 as discerned from the legislation and as recorded in the
39 debate that took place when the legislation went through
40 Parliament. It's clearly the view of the Government as
41 inferred from the Government Policy Statement, but we also, I
42 think in our original material, gave you evidence of a recent
43 speech by the Minister which points in the same direction.

44 The industry have said to you that they don't just
45 support the proposal, but do so on the basis that it holds out
46 the prospect of better decision-making in their opinion.
47 Importantly, while the consumers have come and raised concerns
48 about particular aspects of the Rulebook, their clear
49 preference is still, as I interpret their submissions, for an
50 industry arrangement, albeit one of a slightly different

1 character.

2 That leaves Transpower, and I think it is right to say,
3 that Transpower alone, certainly virtually alone, assert the
4 superiority of the Crown EGB in terms of decision-making.

5 I suggest that the examples that they have given to
6 suggest that industry decision-making is inferior, are not
7 numerous and the most significant examples that they pointed
8 to, the discussion in particular in relation to financial
9 transmission rights, is a discussion which has largely taken
10 place outside the current Rulebook structures. FTRs would
11 certainly have implications for NZEM, but the working groups
12 that have discussed that have been not been part of the NZEM
13 process.

14 The other example that Transpower referred to related to
15 decisions taken within NZEM in relation to loss of constraint
16 rentals. All I want to say about that is, that that episode
17 clearly relates to the discussion about financial transmission
18 rights. I think one could fairly characterise NZEM's
19 decisions in relation to loss of constraint rentals as a
20 tactical response to the debate that was going on at the time
21 in relation to financial transmission rights.

22 What I would like to do is take you, I'm now at the
23 third bullet point in item 1. I'd like to refer you to
24 paragraph 433, it's at page 16. We make the submission that
25 the position that Transpower have now adopted favouring the
26 Crown EGB's decision-making processes over an industry
27 Rulebook, is inconsistent with their own support for Part F
28 and also inconsistent with the arguments that they made back
29 in 1999 in relation to MACQS. Perhaps what really matters
30 here is not so much the inconsistency as the value I believe
31 one should attach to the arguments that they advanced at that
32 time.

33 If you look at the bottom of page 16, we record in para
34 433, material that was submitted to the Commission when
35 Transpower sought to have MACQS authorised, although MACQS is
36 an industry arrangement, Transpower had been its sponsor and
37 it was Transpower that promoted the application for MACQS to
38 be authorised.

39 In the first paragraph we've cited there Transpower I
40 think summarise the nature of the arrangement. "The intention
41 of the change in policy is to enable grid users to determine
42 the quality of electricity supply they require. In recent
43 years such matters have been determined unilaterally by
44 Transpower rather than by generators and consumers.
45 Transpower has been responsible for setting quality of
46 electricity supply. In each of these areas there are trade-
47 offs and choices to be made."

48 Then we come on to I believe an important passage.

49 "Transpower believes that increasingly it will not have
50 all the information necessary to make well-informed decisions

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1 in relation to quality. While Transpower has experience in
2 deciding what needs to be done in order to provide a secure
3 grid, it does not have the best available information with
4 regard to the particular value that individual grid users
5 attach to different levels of quality. Grid users are more
6 aware of their own interests than are other parties. Quality
7 of electricity supply affects grid users more directly than it
8 affects Transpower. Grid users are in a better position to
9 evaluate the costs and benefits of different levels of
10 quality. Nor does Transpower have a complete understanding of
11 the commercial arrangements that could be used to achieve
12 desired levels of quality. The proposals will create an
13 opportunity and provide the incentives for grid users,
14 Transpower and providers of ancillary services to search for
15 innovative solutions."

16 In short, Transpower said:

17 "The objectives of the proposed arrangements are to
18 ensure that decisions reside with those who have the best
19 information and incentives relevant to the decision and to
20 ensure that decision-makers are accountable, under contract,
21 for their decisions."

22 Now, what we say is, that what Transpower said then
23 about MACQS was right, but was right not merely in relation to
24 quality issues, but could apply equally, and does apply, as
25 the underlying rationale in favour of the decision-making
26 processes contained in the Rulebook generally.

27 **MS BATES:** I think its problem was with the narrowness of the
28 appeal rights under Part F and what they would require to
29 agree is wider appeal rights.

30 **MR CAYGILL:** Then -- Commissioner, I think that's very helpful.
31 I must say, listening to Transpower's evidence, and I've been
32 able to listen to most of it, it had not seemed to me that the
33 comparison between the Rulebook and the counterfactual in
34 terms of the efficacy of decision-making boiled down to the
35 narrow, solitary issue that Part F lacks an appeal right.

36 **MS BATES:** I'm talking about the problem with Part F, sorry I
37 must make that clear.

38 **MR CAYGILL:** No, I agree that --

39 **MS BATES:** Two things about Part F, one was the mandatory nature,
40 they wanted mandatory and I think the other thing was wider
41 appeal rights.

42 **MR CAYGILL:** Yes. Those clearly are the concerns that Transpower
43 has about Part F and I'd be happy to address them specifically
44 if that's going to be helpful. I think I'm trying to make a
45 wider point. That is that we understand Transpower to have
46 argued more generally that industry decision-making does not
47 provide the benefit that the applicant asserts it does. We
48 say our Rulebook will deliver a better quality of decision-
49 making compared to the counterfactual, which has obviously or
50 has closely involved the industry, does not assign decision

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1 rights to the parties who are most directly affected in the
2 way that the Rulebook does. That assignment of decision
3 rights we argue is superior, yields a benefit, both in Part F
4 and more generally. The rules in relation to Part F -- as
5 distinct from decisions taken under it -- the rules in
6 relation to Part F will develop under the Rulebook based on
7 the votes of parties who are affected by those rules. That is
8 not the case under the Crown EGB one assumes, one doesn't
9 imagine that its rules will be submitted to votes of the
10 industry.

11 So, we argue that there is a superiority of decision-
12 making generally in the Rulebook as compared to the
13 counterfactual. Now we say, and the reasoning behind that
14 argument, is reasoning which we can't frankly improve on, the
15 best way that has been summarised recently is precisely what
16 Transpower said to you in relation to common quality decision-
17 making in 1999 and because we think that we should do so. In
18 paragraph 4.34 we've then recited for you what the Commission
19 itself concluded in relation to that submission. I won't read
20 that out. But it's plain that that reasoning commended itself
21 to the Commission three years ago and all we say is that
22 reasoning, while its applicable to quality issues, is not
23 confined to it and applies to the Rulebook as a whole.

24 If I then contrast the Rulebook's decision-making
25 processes with the decision-making processes under the Crown
26 EGB, the simple point we make there is the Crown EGB, the
27 ultimate decision-making rests with the Minister and if I
28 might try and put a delicate point this way, Ministers come in
29 many shapes and sizes and this is not a point about capacity.

30 **MS BATES:** Genders.

31 **MR CAYGILL:** Indeed, though frankly I don't regard that as so
32 relevant, but -- it certainly doesn't go to capacity. The
33 point is the set of institutional structures that surround a
34 Minister, compared to the institutional structures in a
35 contractual Rulebook. If one might use the language of
36 comparative advantage, I believe that Ministers have a
37 comparative advantage when it comes to setting national
38 priorities, when it comes to stating the large objectives or
39 outcomes that an industry ought to be set, when it comes to
40 identifying problems that ought to be addressed.

41 But on the other hand, when it comes to developing the
42 detailed rules that answer those problems, there the
43 comparative advantage lies with the parties who are most
44 directly affected, the parties whose contractual arrangements
45 need to be altered in order to satisfactorily address those
46 outcomes. It's not a matter of personal capacity in the
47 slightest. It's a matter of institutional structure.

48 We said earlier and I took you through the checks and
49 balances that lay around the industry Rulebook to counter the
50 argument that there is a risk that pro-competitive rule

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1 changes will be frustrated. Equally on the benefit side, we
 2 say it is a benefit that those checks and balances will
 3 produce superior decision-making as compared to the
 4 counterfactual. Precisely the mechanism of checks and
 5 balances which will help to ensure that pro-competitive rule
 6 changes are not frustrated, that same set of mechanisms will
 7 produce more transparent decision-making which will produce a
 8 superior result.

9 The next point relates to consumer representation and I
 10 want to spend a little time on this if I might, if I take you
 11 to page 19.

12 **CHAIR:** I think perhaps just for our transcriber, sorry.

13 **MR CAYGILL:** By all means.

14 **CHAIR:** Perhaps say 5 past 1 we'll start again.

15
 16 **Adjournment from 1.00 pm to 1.10 pm**

17
 18 **CHAIR:** I think we'll resume. I've had an informal request. The
 19 opinions submitted on behalf of NZEM in relation to the
 20 consequences of changing decision 280, it's been requested
 21 that that be circulated as new evidence which the Commission
 22 will do and give people three or four days to comment on it,
 23 just so it's all been as transparent as we can. All right
 24 Mr Caygill please continue.

25 **MR CAYGILL:** Mr Caygill, I think I was at the sixth bullet point
 26 under the first heading of benefits.

27 **MS BATES:** Consumer representation.

28 **MR CAYGILL:** Indeed. If the Commission would care to turn to
 29 page 19, I just want to take you briefly through the material
 30 at paragraph 4.44. In some way this material relates to the
 31 arguments advanced by Transpower in support of the MACQS
 32 arrangements and perhaps goes one layer deeper in analysing
 33 the rationale for assigning decision rights to parties who are
 34 directly affected. This material also, however, responds to a
 35 different argument, which was the argument of MEUG, that any
 36 person affected by a decision should have a right to vote on
 37 that decision. The decision rights should not merely be
 38 assigned to the industry, but should be assigned, not on a
 39 specific chapter by chapter basis, but assigned to everybody
 40 who might be said to be affected in some way. I want to
 41 respond to that preference. It's not actually a proposal in
 42 front of the Commission, and in doing so explain the rationale
 43 for the allocation of decision rights.

44 Perhaps I should say at the outset that the decision-
 45 making by the Establishment Committee in relation to this
 46 matter was careful, was considered. The issues were discussed
 47 at considerable length on a number of occasions and I am not
 48 comfortable at all with a characterisation of the outcome
 49 which implies that parties simply voted for a set of rules, or
 50 a set of arrangements which reflected their own self-interest.

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1 However much the result may be open to that interpretation,
2 that interpretation does not characterise fairly the processes
3 that were used and that I witnessed.

4 If we start with the proposition from MEUG that any
5 person affected by a decision should have a right to vote on
6 that decision, that implies, I suggest, that all parties will
7 be involved in every decision along the value chain. We
8 suggest that intuitively that does not make sense or produce a
9 practical result.

10 The proper principle, we suggest, is a principle which
11 will best maximise economic welfare and particularly dynamic
12 efficiency. It begins from the point that efficient
13 investment and indeed economic growth are both underpinned by
14 robust property rights. That is to say rights which assign to
15 asset owners the capacity to determine how those assets are
16 used, how they are transferred, the value that they have.
17 Asset owners have the best information about such matters and
18 the greatest incentives and capability to make decisions in
19 relation to the maximisation of asset value. That's the
20 point, it seems to me, that Transpower were making in relation
21 to MACQS.

22 So, what we have said, what the Rulebook says, is that
23 each part of the Rulebook specifies rules which affect groups
24 of assets. The differences between the chapters reflects
25 different groupings of rules, different functions within the
26 Rulebook and will impact on different kind of assets. The
27 multilateral contract in effect requires parties who join it
28 to seed unilateral rights. The contract will affect what they
29 can do, how they can behave, has implications therefore for
30 the value of the assets that particular rules affect. In
31 return for agreeing to be affected in that way, it is
32 appropriate that parties should receive voting rights
33 accordingly.

34 A single voting allocation that covered the entire
35 Rulebook would have the result that parties would be voting in
36 areas where their contractual and legal rights are not
37 altered. If, for example, distributors could vote on trading
38 arrangements. They would be voting about matters which do not
39 directly affect their assets, the value of those assets.
40 Rather they affect the value of other party's assets. In a
41 sense, in the sense that MEUG advanced, they might indirectly
42 be said to be affected. But that is not in the Establishment
43 Committee's reasoning, a sufficient relationship.

44 If we take a different example, if we said Transpower
45 are a member of these arrangements, fine, then they can vote
46 just because of that on customer switching. Transpower are
47 not involved in the customer switching regime at all. Part E,
48 which deals with those matters, doesn't assign them voting
49 rights. There seems to be no obvious need to do that.

50 We say that a voting by chapter approach improves

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1 efficiency by limiting voting rights to parties whose rights
 2 are altered, whose property rights are altered, in that
 3 particular area. That takes the principles articulated by
 4 Transpower, the principles accepted by the Commission in
 5 relation to the quality rules, contractual rules in relation
 6 to quality, and now applies those general principles in a
 7 particular way. Yes, we have a choice as to how voting rights
 8 should be allocated, who should determine how rules could be
 9 altered, but the most efficient principle in that regard is
 10 the principle we have settled on here.

11 The argument that consumers should automatically gain
 12 voting rights in circumstances where their contractual rights
 13 are not altered by the rules would weaken the decision rights
 14 in the hands of those parties whose contractual and legal
 15 rights are altered. That would be a less efficient
 16 arrangement and that is the reason that the majority of those
 17 on the governance working group and the Establishment
 18 Committee rejected that argument.

19 Consumers are, however, automatically allocated votes.
 20 This is an important point, because I don't know that it was
 21 always clear in the evidence. Consumers have votes in
 22 relation to the election of the board, a third of those votes.
 23 But they also have votes in relation to the governance
 24 arrangements, Part A. They have votes in relation to the
 25 common quality arrangements, part C. They have votes in
 26 relation to the new service elements of Part F. They have
 27 votes, finally, although the paragraph doesn't acknowledge it,
 28 but they also have votes in relation to part I which is the
 29 transitional arrangements. Not terribly important but just
 30 for the sake of completeness.

31 Perhaps this is of significance, I'm not sure, but it's
 32 a curiosity we thought we should observe. Consumers in the
 33 areas I've suggested have a third of the votes. Transpower
 34 typically has 16%, more or less. Transpower has a share of
 35 the distributor's votes represented by its proportionate asset
 36 value, and approximately that looks like around 16% of the
 37 total votes. If Transpower and the consumers are of the same
 38 mind, they have almost half of the total votes. I'm not sure
 39 what conclusion to draw from that, but it's certainly not the
 40 case that consumers lack the capacity to influence outcomes in
 41 a number of areas.

42 **MS BATES:** Did you just say under Part F that consumers have
 43 votes with relationship to new services?

44 **MR CAYGILL:** Yes, that's exactly what I said. What I'm talking
 45 about of course are the rules that govern the new service
 46 arrangements, as distinct from the definition of the existing
 47 services, which is part 1, section 1 of Part F.

48 **MS BATES:** But no votes as to what investments are going to be
 49 made?

50 **MR CAYGILL:** Well, that would depend. That would depend. Some

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1 consumers I imagine, to take the Bay of Plenty example that I
2 referred to earlier, because it's the most obvious constraint
3 at the moment. I have no doubt at all that some direct
4 consumers are very likely to be involved in discussions about
5 whether fresh investment should occur, transmission investment
6 or generation investment, in response to that constraint. So,
7 consumers are not excluded from the coalitions that might
8 occur in relation to Part F and in a number of instances I
9 think one can be confident that significant consumers are
10 likely to be involved.

11 **CHAIR:** Thank you.

12 **MR CAYGILL:** Then I just wish to observe in relation to the next
13 point, Professor Hogan I think in effect argued that the most
14 superior arrangements would be industry arrangements that had
15 features not contained in our Rulebook, but the simple point
16 to be made here is that that's not an available model. Who
17 knows how our Rulebook may evolve over time. But the choice
18 that confronts the Commission is a choice between the Rulebook
19 as proposed and the counterfactual. Having gone that far, it
20 occurs to me that it might hopefully be helpful to the
21 Commission to make just this one point about the American
22 system.

23 One way of characterising the difference between the
24 arrangements in that country and the arrangements here is that
25 in New Zealand, both at present and under the proposed
26 Rulebook, we clearly have very highly articulated industry
27 rules. Without pretending that I'm an expert on the PJM
28 model, having taken an interest in it and met with its
29 managers in Pennsylvania, it seems to be the case that the
30 industry rules are not as highly specified as our Rulebook.

31 What is clear on the other hand is that in the American
32 system the regulatory regime is very highly specified. Indeed
33 if I could make the same point about the Australian regime.
34 Whereas if one seeks to discern how a Crown EGB might operate,
35 what would the regulatory environment look like under the
36 counterfactual, one has a skeleton, some powers, but nowhere
37 near as much detail as in the Rulebook. I'm not sure what
38 conclusions to draw from that. But I hope it's a helpful way
39 of thinking about the contrast. The two systems have simply
40 developed in different ways and much of the detail that is
41 contained in the American regulatory environment is in our
42 system contained in the contractual specifications.

43 **CHAIR:** And has been to I mean, NZEM --

44 **MR CAYGILL:** Since 1996, we have simply chosen a different path.
45 It's not the case that one system is more regulated than the
46 other. The difference is that the regulatory controls are
47 located in a different place.

48 **CHAIR:** Thank you, yes, I see your point.

49 **MR CAYGILL:** Finally, I just wish to make a comment about the
50 question of whether the industry governance body will have

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1 executive decision-making authority, or perhaps more precisely
2 to respond to the assertion that it won't and that that's a
3 problem. If one looks at page 23, the final paragraph makes
4 the point there that I wish to make.

5 The applicant does not accept the characterisation that
6 the industry EGB will lack sufficient power. We say that the
7 only respect in which it lacks authority that might arguably
8 be thought to reside in the Crown EGB, but in fact does not,
9 is the capacity to unilaterally change the rules. The
10 industry EGB can promote rule changes. It must supervise rule
11 changes. It must negotiate performance targets with the
12 Government. It must subject itself to and cooperate with the
13 auditing of the Auditor-General and the Parliamentary
14 Commissioner for the Environment and so on. It will employ
15 staff, or arrange for such services as it needs. It will
16 negotiate the service contract with a number of service
17 providers of whom the most important is clearly the system
18 operator. That's not an unimportant function and in that
19 respect no rule change is involved, it will have the final
20 decision-making authority to enter into the contract which
21 will lie at the heart of the maintenance of system security
22 and the delivery of market prices, every half hour or every
23 five minutes or whatever. In many respects it will have real
24 decision-making authority.

25 The only thing that it cannot do is unilaterally change
26 the rules. Not even CC 93, including MEUG, have actually
27 asserted that it should be able to have that power, because
28 importantly, I'd remind the Commission, when CC 93 came to
29 present their submissions they said, at one point and they've
30 been consistent in this, they would acknowledge that
31 ultimately the industry should have the right to call for, the
32 phrase used is "call through", a vote on a rule that the
33 Governance Board had insisted on or alternatively had
34 rejected.

35 It seems to me, with respect, that a governance board --
36 one can't have it both ways, one can't characterise this board
37 as looking executive authority. The only content to which one
38 can assign to that phrase being the end capacity to mandate
39 rule changes unilaterally, and then acknowledge that in a
40 submitter's preferred universe the industry would still be
41 able to call for a vote on rule changes. Those two things are
42 inconsistent.

43 As I listened to the submissions that have been made,
44 and they're not novel, these are discussions that have been
45 going on for the last year; it is only Transpower who prefer
46 the Crown EGB on the basis that it, in contrast to the
47 industry EGB, would have final decision-making authority. But
48 of course that's not right, because under the Act it's not the
49 Crown Governance Board but the Minister who would have the
50 final authority in relation to rules recommended by the EGB.

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1 So, I've taken longer over the point that I have wanted to.

2 **MS BATES:** Can I just clarify something that goes back to Mr Kos'
3 opening. I may have made a wrong note of it. But I thought
4 Mr Kos, you'll correct me if I'm wrong, that you said there
5 was a reasonable consensus around what the counterfactual
6 would be and that would be a Crown EGB which would largely
7 adopt the Rulebook. So, my question to you, Mr Caygill, is
8 you see it actually diverting from the Rulebook in fairly
9 significant respects?

10 **MR CAYGILL:** There's no disagreement between Mr Kos and myself.

11 **MS BATES:** No, I'm just trying to clarify.

12 **MR CAYGILL:** Yes, I think there is no reason -- I'm entirely
13 comfortable with the premise that the Crown EGB is likely to
14 pick up most of our Rulebook. If nothing else I'd like to
15 think that our work hasn't been entirely wasted, or doesn't
16 depend on a single regulatory decision. But it seems to me,
17 having said that, it's one thing to say the detailed
18 mechanisms in Part F can logically be picked up by a Crown
19 EGB, or --

20 **MS BATES:** Which is what Transpower are advocating for with some
21 limitations or extensions.

22 **MR CAYGILL:** Yeah, but my point is simply a Crown EGB could
23 readily pick up those mechanisms. A Crown EGB would
24 presumably have no difficulty with the retail switching
25 mechanisms in part E, or the common quality mechanisms in
26 part C. But the notion that future rule changes should be
27 approved by a vote of industry participants seems to me not to
28 sit comfortably with the responsibilities that a Crown EGB
29 would be required to exercise. I can't make more than that of
30 the point. We simply don't know.

31 It just seems a strange Crown entity that is appointed
32 by a Government to recommend rules in respect of an industry
33 and yet is then hobbled in its capacity to make
34 recommendations by a requirement that the only recommendations
35 it can put up are recommendations which have been ticked off
36 by an industry. Certainly the Act doesn't say that would
37 happen. Doesn't say it wouldn't, it's silent. We must use
38 our best judgment.

39 Much of the debate while for the most part people have
40 accepted that the Crown EGB is the counterfactual, they've
41 then said, however, it is either the superiority of industry
42 decision-making as against a counterfactual which stands in
43 favour of the industry Rulebook, the applicant's position, or
44 that is not the case, the Crown EGB, the industry EGB would
45 not have superior decision-making capacity. Well, if one says
46 the decision-making capacity would be the same, I guess the
47 point is moot, but I didn't understand that to be Transpower's
48 argument.

49 **MR KOS:** There seem to be two respects on which a difference
50 between the Crown EGB and the industry EGB seems to be

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1 identified as a reasonable potentiality. One is the ability,
2 which have we've covered in the question of investment, under
3 or over-investment for a Crown EGB, possibly through a
4 Minister ultimately, to force investment. That seems to be
5 one particular model difference. The other one which we're
6 not so sure about is the one that David's just been talking
7 about, which is well on a rule change issue, which is
8 different from forcing investment, perhaps a Crown EGB would
9 have more unilateral powers, but we don't know.

10 **MR HANSEN:** Can I perhaps just come in there. I think one thing
11 that Alex Sundakov said that the key here was what is the
12 distance between the decision-maker and the Government, and he
13 suggested that there was very little difference between the
14 two arrangements. But I think if you break down decisions
15 into generic categories there's, for example, specifying rules
16 and possible changes, there's monitoring type positions and
17 there's enforcement type decisions.

18 I think what we've argued quite consistently is that
19 those various decisions need to be allocated to different
20 parties who have a comparative advantage in those decisions.
21 Our position has been that specifying rules, that the industry
22 parties and their working groups and so on, have distinct
23 comparative advantage. Where we tend to agree is that there
24 is value in having, for example, regulatory threat or
25 Ministerial oversight, other bodies getting involved in
26 monitoring and enforcement.

27 So, I think to categorise it as just all decisions in a
28 unidimensional sense is to gloss over really what this is
29 about.

30 **MS BATES:** I suppose I was exploring the limits of the consensus
31 really.

32 **MR KOS:** Thank you Mr Chairman. Probably the next, unless
33 there's any more questions on that topic, we would move fairly
34 quickly through the balance of the right-hand column.

35 **CHAIR:** Please do.

36 **MR KOS:** David, if you'll take number 2 quickly please.

37 **MR CAYGILL:** Whereas it is said that one of the risks, one of the
38 detriments that needs to be weighed, is the capacity of the
39 industry to hold up pro-competitive rule changes, or as we
40 would assert that's not the case. On the other hand we say
41 one of the benefits in the industry arrangement is that it
42 reduces the risk that would arise under a Crown governance
43 body that the transmission provider, or system operator, might
44 in turn frustrate competitive developments.

45 I think what the Commission has heard in relation to
46 this point, is that some forms, at least, of technological
47 innovation, demand side participation for example, or
48 distributed generation is another example, involve trade-offs
49 with system security. I absolutely accept that the system
50 operator, Transpower, has legitimate concerns which its

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1 obliged to weigh in that regard. The point is simply that
2 process raises the risk that the greater intimacy as between
3 Transpower and the Government body and the reduced
4 transparency of that relationship, makes it more likely that
5 under the Crown entity arrangements pro-competitive
6 developments which involve trade-offs with system security
7 will not proceed as readily.

8 The other consideration which has been put in issue in
9 front of you, we say is that it is also possible that the
10 system operator may give undue regard to the impact of
11 competitive changes on transmission asset values, and while I
12 would acknowledge that Transpower's Statement of Corporate
13 Intent, or indeed arguably the ODV valuation system should
14 mean that Transpower is indifferent in that regard, I simply
15 observe that Todds gave you an example where they said that
16 was not the case.

17 We say that there are difficulties in a Crown model for
18 the Minister intervening to reduce this risk, or tendency.
19 The Minister is advised by the EGB and able to be advised
20 directly by Transpower. We say that if one thinks about the
21 concerns that a Minister is likely to have, it is not
22 unreasonable to conclude that a Minister is likely to give
23 weight to security concerns, to be cautious in that regard,
24 and that suggests both an over-investment risk that we'll come
25 to in a moment, and also the risk that competitive
26 developments may be, to that extent, at the margin frustrated.

27 If one turns just quickly to page 33, you can see there
28 we have elaborated on this argument. I simply want to make
29 the point at paragraph 7.15, that whereas central decision-
30 makers have a poor track record in relation to large
31 investments in the past, and we don't need to go over that
32 familiar history, I think an important point here is that
33 we're talking about investments where the Minister does not
34 have any financial authority, or face the need to secure
35 appropriations. That is somebody else's dollars who will be
36 involved if the argument is that in the cause of security,
37 investments are necessary or rule changes should be held up.

38 At the risk of sounding as though the applicant has some
39 hobbyhorse about Transpower, I think it is worth reminding the
40 Commission of a recent example. The Commission is clearly
41 familiar with the Electricity Amendment Act. If, when you
42 have a moment, you turn to section 19 of last year's
43 Electricity Amendment Act, that is the provision which was
44 inserted at the last minute by way of supplementary order
45 paper, in other words without the opportunity for public
46 debate, to provide legislative mandate for Transpower's
47 pricing methodology. It's a temporary mandate. It will in
48 effect expire when the arrangements in this Rulebook are able
49 to be put in place. That's fine.

50 My point is not that there's something wrong with what's

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1 been done. My point is that what was done in sections 19 and
2 20 was absolutely at the behest of Transpower, and is a good
3 example, I submit, and a recent example of their capacity to
4 win the ear of Ministers when they believe they have a need to
5 do that.

6 **MR KOS:** That was the reason why the Meridian case on posted
7 terms, which I was counsel for Meridian, wasn't appealed.
8 That was its conclusion. What I can say in addition to what
9 David said is that there was intense lobbying of the Minister
10 in relation to that particular point. It can't be said it was
11 a one sided lobbying, there was lobbying from both sides as
12 soon as Meridian and Trans Alta were aware that that was
13 happening. They too lobbied, but the outcome is precisely one
14 you've just indicated, speaks for itself.

15 **CHAIR:** Thank you.

16 **MR CAYGILL:** I'd make the point again, and again I won't dwell on
17 it, in relation to the risk that the transmission provider,
18 system operator will have greater opportunity under the Crown
19 arrangements to frustrate competitive developments, again the
20 industry decision-making is relevant here and the arguments
21 that Transpower made in relation to MACQS apply now with the
22 reverse. That is to say they apply to explain why that is
23 inferior outcome.

24 We say simply that the industry EGB provides an
25 appropriate process, indeed now a proven process, for
26 balancing security and cost and we give the example of the
27 solution to under-frequency. The new standards in relation to
28 under-frequency took a long time to emerge, to be settled on.
29 But there is a considerable net present value benefit and they
30 are a good example of precisely what Transpower was looking
31 for when it supported the MACQS arrangements. I'm not sure
32 whether --

33 **MR KOS:** Thank you, Mr Chairman members of the Commission. The
34 next point, avoidance of over-investment, we have just four
35 short points to make about that topic. The first follows on
36 from what has just been said. It is that the Minister is
37 likely to emphasise security. We've seen that in relation to
38 the Treasury report on dam investments in New Zealand which is
39 exhibited, or referred to in Contact's submission. You will
40 remember there's a graph there which showed a preference for
41 investment -- well in fact the conclusion that there was a
42 preference for over-investment -- in that case, David's just
43 said throughout the 1960's, 1970's into the 1980's in relation
44 to investment, at a time of course when all of electricity
45 infrastructure, apart from the lines retail function, was
46 Crown owned and so Crown was paying. The distinction we've
47 drawn attention to here under the new arrangement, if there is
48 forced investment at the behest of the Minister or Crown EGB,
49 the Crown doesn't bear that cost and doesn't then seek
50 appropriation, seems a relevant observation to make.

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1 **MS BATES:** Well, just to note the obvious point that the Crown
 2 does have interest as owner in a significant portion of these
 3 assets. So, it's not quite right to say it's not going to be
 4 economically effective.

5 **MR KOS:** I acknowledge as a shareholder that's right. The point
 6 I really wanted to make here, at the risk of going to fast to
 7 actually miss the point. It was suggested I think by
 8 Commissioner Curtin that possibly that study was really out of
 9 date and irrelevant. I think it's important because it is a
 10 study of New Zealand conditions running up until about 15
 11 years ago or so, and shows what happens in this environment
 12 when you have centralised control of investment in relation to
 13 these sorts of assets.

14 **MS BATES:** Yeah, so it was pre-1984 and one would have to accept
 15 the philosophical change that's come about permeated the whole
 16 of the country since then.

17 **MR KOS:** Yes, although the question I suppose here is the extent
 18 to which that philosophical change is turned back if one has
 19 the implementation of this legislation, Crown EGB.

20 The second short comment I'll ask James Palmer to deal
 21 with because it's probably better in his hands.

22 **MR PALMER:** This is really an elaboration of paragraph 7.17, but
 23 I'll just depart from our notes a little and expand on it. In
 24 the Draft Determination the Commission found that the
 25 counterfactual in regards to transport was Part F as in the
 26 proposed Rulebook, but with a Crown EGB or Minister having a
 27 final decision right in relation to investments, so in other
 28 words it can force investments to occur. There was no detail
 29 given as to in which situations it would force investments,
 30 other than the idea of a net public benefit, or how those
 31 would be funded.

32 Transpower, as I understand its argument, in saying that
 33 there would not be over-investment in the counterfactual, has
 34 attempted to add detail to the counterfactual. It does that
 35 in two ways. It says that firstly there won't be over-
 36 investment occurring because the Crown EGB will only be able
 37 to push the investment button if there's been, firstly if a
 38 transmission provider is proposing a particular investment,
 39 secondly if it's been voted on and turned down twice with a
 40 year's gap in between. We submit that that's an implausible
 41 rule to apply if you do have the Crown EGB as a final
 42 decision-maker for investments.

43 If the Crown EGB and the Minister takes on
 44 responsibility and accountability for making final
 45 transmission investments, why would it tie its hands to have
 46 to wait for two votes and to have to have a proposal before
 47 it. As Transpower itself has submitted that matters of delay
 48 would be important in investment decisions and it just seems
 49 completely inconsistent that the Crown would set up a system
 50 of rules where it is accountable but only have the power to

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1 enforce investment if there's a proposal which has been voted
 2 down twice. In our submission whatever form the
 3 counterfactual took it would leave the Crown EGB with a
 4 broader power to invest.

5 The second reason Transpower gives for saying that there
 6 won't be a problem with over-investment, is that it says that
 7 forced investments will still be subject to the ODV regime.
 8 We submit that again this doesn't seem like a credible regime.
 9 In a situation where Transpower or a different transmission
 10 provider is forced to invest, fairness seems to dictate that
 11 they would be fully compensated for that investment. But
 12 because the Crown EGB is saying you, Transpower, invest, that
 13 Transpower shouldn't be the ones subject to a risk of the
 14 investment being written down by ODV, particularly in light of
 15 the Crown as the shareholder for Transpower, it seems unlikely
 16 they would subject to a regime where they'd get forced to
 17 invest, but then bear the risk that the value of that
 18 investment is cut down in the future.

19 So, our submission is that, although there's agreement
 20 at the high level over the counterfactual, that the Crown EGB
 21 would have the power to push the investment button, that the
 22 actual detail given by Transpower seems implausible and
 23 therefore the --

24 **MS BATES:** I do want to clarify this, as I understood Transpower
 25 on the question of investment to be opting for a party
 26 situation with wider appeal rights and that the decision --
 27 and because I was surprised at the time that that was being
 28 put forward, so I don't quite follow how it would be, if that
 29 was in, it would be a Ministerial decision. They were saying
 30 in effect that it would be a decision under Part F with appeal
 31 rights to the Crown EGB.

32 **MR PALMER:** As I understood it they didn't take a clear stance on
 33 whether it would be the Crown EGB or the Minister that would
 34 have a final decision right.

35 **MS BATES:** I understood it was a Crown EGB, but anyway.

36 **MR PALMER:** Regardless, the key aspect is that in reality, if
 37 you're giving the Crown EGB the responsibility for making
 38 those decisions, it wouldn't be confined to the appeal right
 39 decision of only being able to make that decision if someone's
 40 put forward a proposal and it's been voted down twice with a
 41 year's gap in between. It just doesn't seem like a sensible
 42 arrangement that you give the Crown EGB responsibility and
 43 accountability, but have a very limited channel for it to say
 44 yes, invest.

45 **MS BATES:** I'm just putting to you what Transpower put to us.

46 **CHAIR:** All right, thank you.

47 **MR KOS:** The last, I said there were four points. The third one
 48 is simply the one that's listed there which is that we submit
 49 the past record of under-investment by Transpower which was
 50 held up as an indication of what might happen in the future is

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1 no effective guide, because different constraints applied
2 hitherto with a lack of any central imposition of investment
3 which is the effect of the counterfactual in this case.

4 The fourth point I'd make, just quickly, is that in a
5 sense you can see a kind of potential net-off start to emerge
6 as one looks down this chart. I mean on the one hand we have
7 item 1 in detriment strike down of potential pro-competitive
8 rule changes and we have item 2 in the right-hand column, less
9 risk of transmission provider system operator strike down.
10 Everyone of course -- the main protagonists are saying, these
11 are overstated. To the extent we say for instance that there
12 is a risk that Transpower will strike down pro-competitive
13 changes, no doubt they would say that's overstated and
14 likewise we say that their view of the potential for strike
15 down by the industry of pro-competitive changes is also
16 overstated.

17 At the end of the day the Commission and the Commission
18 staff will do the mathematics, but one can see a kind of a
19 net-off across one and two, across the column, likewise in
20 relation to investment. Two in the left-hand column and three
21 in the right-hand column and in my submission, in my view, in
22 relation to over-investment, if there is a serious
23 overstatement on either part in terms of value, you end up
24 with a kind of net-off of the two propositions. So again the
25 mathematics has to be done, the valuation has to be done, but
26 these things in a sense conflict and one or the other must
27 apply.

28 Now we're going to deal with cost of capital, there are
29 just I think three points that Dr Palmer and Dr Hansen want to
30 deal with there.

31 **MR. HANSEN:** The Institute of Economic Research particularly
32 suggested that even admitting some form of cost of capital
33 estimate into the framework was inappropriate, that the pre-
34 existing traditional approach of looking at allocation
35 production and dynamic efficiency covered the full range of
36 issues. The approach that we take is that those efficiency
37 calculations are really calculated on a certainty equivalent
38 basis, to some extent they have ranges in them, but they don't
39 incorporate the welfare consequences of risk in and of
40 themselves, the efficiency calculations. They look at
41 scenarios of possible outcomes. We believe the welfare
42 aspects of risk are an important additional factor. In
43 particular in an industry with large long-lived assets where
44 risk can affect cost of capital and therefore have quite a
45 significant impact on people's actions in terms of investment.

46 We do not agree in 13.5, for example, that the cost of
47 capital is merely a transfer from one party to another. If
48 you have an increase in risk, then the investor is supplying
49 money or finance and expecting a higher return, but that
50 investor is bearing higher risk. The higher return is exactly

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1 an offset or a compensation for that higher risk. In the
2 meantime, the company that is receiving the finance is paying
3 a higher cost and therefore it's the net detriment. I think
4 I've probably covered the main points there, there are other
5 point in the text there but that's main aspects.

6 **CHAIR:** There's just the double counting of 13.4, the comment on
7 double counting.

8 **MR HANSEN:** That was the first point I made really was the double
9 counting, that the efficiency calculations are really based on
10 a certainty equivalence approach. They don't actually try to
11 measure any impact from risk per se.

12 **CHAIR:** Thank you.

13 **MR KOS:** That's that topic. I want to take the next three
14 together because these are -- we're really down now into much
15 smaller items. So, could I just make three points about them.
16 First is, taken together, 5, 6 and 7 have a valuation in terms
17 of the applicant's calculations, between 19 and \$38 million
18 positive. That's the range taken together.

19 The second point we want to make is one that David
20 Caygill wants to address briefly in relation to 5 and I have a
21 short point on 7.

22 **MR CAYGILL:** Can I take you to page 37 of the full notes of
23 reply. The argument here is whether the industry arrangements
24 are more likely to promote contestability of service provision
25 than the Crown arrangements. The applicant asserts that that
26 is the case. The industry has -- the most important service
27 is the operation of the system. The industry is keen to see
28 that rendered contestable and has made that plain on a number
29 of occasions, going back to the inquiry and perhaps with
30 increasing strength, over the time since.

31 I think it follows from that clear and understandable
32 preference that one can conclude that industry arrangements
33 are more likely to promote service contestability, at the very
34 least in the most important area of system operation than
35 Crown arrangements.

36 The only question that perhaps needs to be addressed is
37 the one raised by NZIER who appeared to suggest that
38 ultimately the question of whether the system operation could
39 be contestable is a decision which would not be open for the
40 industry to make, but would lie with the Government. I do not
41 believe that that's correct. I don't say -- put it
42 positively, I acknowledge that the Government may well have an
43 interest in the matter. They own Transpower. If Transpower
44 were to lose the system operation function, as shareholder
45 they may well not be indifferent.

46 But the fact is that system operation is a service
47 supplied by Transpower at present as a matter of contract with
48 NZEM, first and foremost. It's slightly differently
49 described, system operation is not a label used in the present
50 Rulebooks, and the services are organised in a slightly

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1 different way under the Rulebook. But their character as a
2 service supplied pursuant to a contract, is not novel to the
3 proposed Rulebook, that is precisely the arrangement at the
4 moment. There is nothing, I submit, that would prevent the
5 industry, under NZEM, from seeking to make system operation
6 contestable now. It's not proposed, but it would involve no
7 need to seek permission from the Government at the present
8 time, it would just involve changing contractual provisions.

9 The Rulebook provides that Transpower will be the
10 initial system operator, because that is the understanding
11 that the Establishment Committee has had all along with
12 Transpower. It seems a sensible thing. They have the
13 expertise at the moment. However, it was envisaged quite some
14 time ago under MACQS that when the initial term that
15 Transpower would have as the provider of the common quality
16 services, one aspect of the system operation, when that
17 initial term had expired, consideration would be given to
18 whether that future contract would be contestable. There has
19 never been any suggestion that that decision would require any
20 explicit approval of Government. There is no obvious case for
21 that, that I can see, indeed no specific mechanism whereby it
22 would happen.

23 **CHAIR:** I think it was acknowledged by Transpower in discussion
24 that the ownership issue from Government didn't really
25 influence that precise decision.

26 **MR CAYGILL:** And my point is that it's only as owner of the, or
27 employer I suppose, owner of the revenues earned as system
28 operator, that the Government has any direct concern. It's
29 certainly possible that they could introduce into a policy
30 statement some requirement.

31 **MS REBSTOCK:** Why do you think -- my understanding was the GPS
32 currently says something to the effect that the Governance
33 Board could approach the Government about making it
34 contestable. It almost seems like the Government thinks it's
35 its decision to make.

36 **CHAIR:** I don't think Transpower actually questioned what you say
37 when it was asked of them.

38 **MR PALMER:** I think the simple fact is once they sign the
39 Rulebook they're consenting to the contestability provisions.

40 **MS REBSTOCK:** Sure, I do understand that, the wording in the GPS,
41 but that's not material.

42 **MR PALMER:** I think it's slightly inconsistent, but it doesn't
43 overrule it.

44 **MR CAYGILL:** I'm unable, I'm afraid, to put my finger precisely
45 on the sentence, but if I could -- just for future
46 reference -- there may well be an inconsistency within the GPS
47 itself. Section 12 of the GPS says:

48 "The Governance Board should be responsible for
49 determining the services to be provided to the market which
50 should be contestable wherever possible."

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1 I simply say there is no engineering reason or legal
2 reason why system operation cannot be made contestable. It is
3 contestable in a number of overseas markets.

4 **CHAIR:** I don't think when it was discussed at length with
5 Transpower they denied that. The ownership thing was
6 mentioned but not as an intrinsic barrier from memory. But it
7 will be in the record somewhere. Thank you.

8 **MR KOS:** The last point we wanted to make was a short one in
9 relation to point 7. When the Commission and the staff look
10 at page 35 of the reply, we've been able to draw some
11 conclusions from the scale of potentially substitute
12 transmission services from matters referred to by Peter
13 Robertson yesterday in evidence. The potential for
14 construction of large scale generation, in the North Island,
15 the consideration of ten alternative technologies for
16 resolving Auckland's things. So we're talking there about
17 problems, talking there about 1.3 billion or so investment.
18 The short point, we wanted to make and draw the Commission's
19 attention to was that on that basis the 10 to \$20 million
20 estimate in relation to MPV for potential competition and
21 transmission services is, in the view of Murray and Hansen,
22 now conservative in light of that further information. Sorry
23 Dr Hansen.

24 **MR HANSEN:** On the issue of traditional dispensations, I think
25 the Commission was correct to point to the cost of capital and
26 the implications of not allowing dispensations of this nature
27 when the response from the Institute was to say well why
28 should it be different from any market when someone goes into
29 a market and they put the assets at risk.

30 The critical difference is in an open market without any
31 governance of this nature, anybody who does that has the right
32 and the ability to sign long-term contracts with people to
33 protect their risk. Those can't be overwritten.

34 This is a situation where the Rulebook in some cases is
35 overriding that right, and so you've got people who are
36 putting up assets maybe for 50 years, subject to a voting
37 process that may change what can be done with those assets.

38 So, I don't think the comparison is there and to not
39 have these sorts of arrangements would be welfare reducing
40 because it would simply increase the cost of capital, to
41 everybody's detriment.

42 **MR KOS:** That's the last submission of substance we have. I
43 think David Caygill would have a couple of comments to make.

44 **MR CAYGILL:** I just simply wanted to thank the Commission for the
45 opportunity that you've given us. This hearing I think has
46 taken longer, I was going to say proved more arduous, than I
47 think any party envisaged. It's been a pleasure to appear in
48 front you and being part of this.

49 It occurs to me that the application that's in front of
50 you represents the culmination of at least three years of

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1 work. Certainly as earlier as 1999 the industry was seeking
2 to bring together the existing Rulebooks. The inquiry
3 endorsed that. The Government Policy Statement, which
4 responded to the inquiry, set out some quite detailed design
5 rules, and it has taken the industry a year to get to the
6 point of complying with those and putting the application in
7 front of you. We look forward to the outcome.

8 **CHAIR:** On behalf of the Commission, can I just thank you for
9 taking the trouble to go into the application in such detail.
10 Secondly, I think in this morning's presentation, obviously
11 considered thoroughly the points made by others. The
12 Commission will go away now and attempt to reach a decision as
13 quickly as practicable because I know matters are urgent.
14 But nevertheless urgency hopefully will not get in the way of
15 sound decision-making because these issues, as you say, are
16 fundamental and have been quite some time in the making and
17 they are also obviously of considerable interest and concern
18 to a wide range of interests, including the applicant.

19 So, just to thank you also Commission staff for A, work
20 done already, and what's going to be a significant amount of
21 work from here on, and to our transcriber and our
22 communications people who have kept the conference going. So,
23 again, to all those who participated and to the applicant,
24 thank you indeed and we'll make our decision as soon as we
25 can.

26
27 **Hearing concluded at 2.10 pm**
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