22 May 2002

Bill Naik
Commerce Commission
PO Box 2351
Wellington

Dear Mr Naik

**Contact Energy's Submission on the Draft Determination by the Commerce Commission on the Application for Authorisation by the Electricity Governance Board Limited**

Thank you for this opportunity to make a further submission on the application by the Electricity Governance Board Limited following the Commission's draft determination.

Whilst we address each of the Commission's questions in the attached paper, we consider it might be helpful if we advise the Commission at the outset of our response to question 48 in order to assist the Commission to narrow the outstanding issues.

In general terms, question 48 asked whether the Commission's review of the relevant issues had been comprehensive. We consider that the Commission has carried out a reasonably comprehensive review of the relevant issues in the draft determination. However, as is apparent in our answers to other questions, we believe the Commission has not always had all the relevant information, or had an opportunity to give the appropriate weight to some of the matters it has reviewed. We believe this has given rise to the Commission's major concerns, being:

(a) a perceived risk that pro-competitive rule changes and efficient transmission investments may be voted down; and

(b) the mandatory nature of the rules may lead to a lack of competition in the markets for the provision of administration, pricing and clearing services.

In our opinion the draft determination has significantly over-stated the ability and incentives of generator-retailers to vote down pro-competitive rule changes and of participants to vote down proposed transmission investments. We further consider that the proposed arrangements will

provide a similar level of competition in the markets for the provision of administration, pricing and clearing services as would be the case under the counterfactual. If there is any difference, we consider that it would favour the proposed arrangements.

A further major point we raise is that we do not consider that the price determination processes contained within the proposed arrangement have the purpose, effect or likely effect of fixing, controlling, or maintaining price or otherwise constitute a breach of s 30 of the Commerce Act.

**Voting down of pro-competitive rule changes and transmission investments**

We believe the draft determination does not take sufficient account of the following factors:

- there is no pattern of generator-retailers using their voting power in existing arrangements to block pro-competitive rule changes;
- the new regime contains a very important new feature which acts as a check on any party or parties seeking to block pro-competitive rule changes. This is the ability by the government to replace the proposed arrangement with a Crown EGB;
- the review role of the Auditor-General and the Parliamentary Commissioner for the Environment in assessing the performance of the EGB;
- generators will have little or no ability or incentive to block desirable transmission investments under the proposed arrangement. This is because transmission investments will largely be determined by those parties who will pay for them. To the extent that generators are involved in such votes, the generators concerned will be those which will benefit from the investment. For the same reasons we consider that distributors will be unlikely to vote down efficient new transmission investments.

In short, we do not believe the detriments perceived by the Commission would arise. At the very least, the quantum of any detriments would be substantially less than those estimated in the draft determination because they would not be allowed to continue – the government would replace the proposed arrangement by Order in Council if a pattern of anti-competitive behaviour emerged.

**Competition in Administration, Pricing and Clearing**

We believe that contestability through time is likely to be greater under the proposed arrangements than under a Crown EGB as the Crown EGB will be at a relative information disadvantage, and is therefore likely to have more difficulty specifying contract terms with external providers.

On balance, we believe that the proposed arrangements may be a little more likely to facilitate bypass than the counterfactual because:

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- bypass of its nature tends to bring more complexity and difficulty to the task of system operator. The arguments of the system operator are more likely to be heeded in the counterfactual because of the relationship it would have with a Crown EGB;
- to the extent that the Crown EGB does keep service provision in house, it will have an internal group with a potential direct stake in the outcome.

**Section 30**

We consider that a process that allows for the normal competitive constraints of demand and supply to establish price cannot be in breach of the price fixing provisions of the Commerce Act. In our view, the draft determination's implication that the wholesale electricity pricing formula in Part G of the Rulebook may constitute a "constraint" on participants, which may in turn bring the process within s 30, is unsound as the formula allows for demand and supply to influence price.

We also consider that the Commission has placed too much emphasis on the "purpose" provision in the pricing section of Part G in implying that Part G may have the purpose of fixing, controlling, or maintaining price. The trading rules provide an organised framework for the efficient and competitive trading of wholesale electricity allowing for price to be discovered in response to demand and supply to impact on price. The discovery of price is an outcome of the competitive trading process.

Whilst we have not carried out a detailed analysis of the cases referred to by the Commission, we consider it unlikely that the judgments in those cases were intended to result in s 30 applying to a process which allows price to be discovered in response to demand and supply.

We take this opportunity to reiterate our view that a government imposed electricity governance board would be a sub-optimal outcome relative to an industry electricity governance board, which we believe would have better incentives to act in an economically efficient manner.

Contact is available to answer any questions the Commission may have.

Yours sincerely

Stephen P. Barrett

**Chief Executive**

## Responses to Questions

The questions set out below are copied from the text of the draft determination, not from the schedule of questions appended to the draft determination.

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

Yes.

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

We accept the Commission's definition of the appropriate markets.

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

No. We agree that the Rulebook constitutes a contract, understanding or arrangement between competitors. However, we do not consider that the Rulebook has the purpose, effect or likely effect of fixing, controlling or maintaining the price for wholesale electricity.

The Commission suggests that the trading rules may create some constraints upon the free action of generators and wholesalers in determining the price for electricity and reserves, and seems to argue that this is sufficient to bring the rules within the ambit of s 30 as an arrangement fixing or controlling the price. The alleged constraint is the fact that the range of bids and offers will be influenced by the knowledge that they will be subject to the formula to discover the final price. The formula in the rules matches supply and demand and does not restrain the range of bids and offers that can be submitted. In our view, rules allowing for the influence of normal competitive constraints (such as the level of supply and demand) to establish price does not bring any arrangement within the ambit of s 30.

The trading rules foster competition in the wholesale market by providing a process to allow the sale and purchase of wholesale electricity in an efficient and competitive fashion. The Commission has noted that the pricing section of the trading rules is designed to *achieve certainty as to final prices and final reserve prices for each trading period*. We believe the Commission has placed too much emphasis on the italicised words as a basis for concluding that the rules may constitute an arrangement with the *purpose* of fixing or controlling the price. The rules are an arrangement between competitors (and customers) to use a bid and offer process to trade electricity, which results

in and requires the discovery of the price. The enunciation of the specific purpose of the pricing section of Part G (quoted by the Commission) is simply a reference to the fact that the price is discovered when the trading rules are followed. We do not consider that rules which have the purpose of allowing price to be discovered via a competitive process (i.e. allowing for the impact of demand and supply) can fairly be described as having the purpose of fixing or controlling the price.

Whilst we have not carried out a detailed review of the cases referred to in the draft determination, we consider it unlikely that the decisions were intended result in a situation where it is a breach of s 30 to discover price via a competitive process which allows demand and supply to impact on the price.

***Question 4:*** *Does the transmission pricing methodology in the proposed arrangements fall within the ambit of s 30?*

No. We agree that the Rulebook constitutes a contract, understanding or arrangement between competitors. However, we concur with the applicant's view that this arrangement merely establishes a process to be used in establishing a pricing methodology which is consistent with the guiding principles and the Rulebook. Accordingly, we believe the *process* does not constitute an arrangement with the purpose, effect or likely effect of fixing, controlling or maintaining the price for transmission services as the sole focus is on ensuring the correct process is followed.

In any event, given that transmission services are an example of joint buying, we query whether s 33 should apply.

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

No. Cost sharing is common practice in business where it leads to efficiencies, even between competitors (consider two competing consultants agreeing to share the cost of a receptionist). In our view, and in accordance with our views in question 3 and 4, cost sharing should not breach s 30 if does not interfere with the impact of demand and supply on price. The cost allocation provisions do not in our opinion have the effect of limiting or restraining the impact of supply and demand on price. In any event we query whether s 33 should be applied to the cost allocation provisions.

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

We refer to our comments in relation to questions 3, 4 and 5. We also refer to paragraph 187 of the draft determination where the Commission discusses the counterfactual. In that paragraph the Commission states that *"In the main these rules have been taken from MARIA, NZEM and MACQS,*

*they appear to work efficiently and do not raise competition or other policy concerns."* We consider that the Rulebook, based heavily on the three existing codes, also does not raise competition or other policy concerns.

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

Yes. However, we consider that over time the guiding principles and operational rules under the two EGB's would diverge due to the different forces influencing their evolution. This would have the effect in our submissions of making a Crown EGB less efficient than an Industry EGB.

***Question 8:*** *Would a change to the proposed Guiding Principles so that they were more closely aligned with the principles and objectives in the GPS be likely to enhance competition or otherwise increase consumer welfare?*

No. It is our view that the GPS and the guiding principles are consistent with each other and for all intents and purposes the guiding principles embody the GPS requirements tailored to allow the GPS to be effected in the multilateral Rulebook. In our opinion the GPS are not "guiding principles" which could simply be pasted into the Rulebook as such, as they are an amalgam of policy statements and outcomes desired by the Crown which in practice would create ambiguity and confusion and may not advance the government's objectives.

In our view, guiding principles must be statements which are broad (comprehensive), robust (operational) and enduring. We believe that the participants in the industry are best placed to develop principles of this kind.

The GPS, together with experience from the three existing codes, provided the background against which the industry has developed the guiding principles. The industry has drawn on this background to develop guiding principles which are consistent with the GPS but which, by virtue of the experience gained from the existing three codes, also provide a clearer basis for practical application to existing and new circumstances and to give effect to the government's intentions embodied in the GPS.

The industry has been extensively consulted and is in our view comfortable with the amount of rigour applied to develop practical guiding principles. In this sense we consider the guiding principles have been tested, both under the existing three codes (to the extent that they are the same) and by virtue of the amount of consultation which has been carried out. We believe that experience under the existing codes will provide an important reference point to an EGB applying the guiding principles.

On the other hand, the GPS has not had the same amount of industry consultation and rigour applied to it.

In our opinion the guiding principles are better developed and more tested than the GPS, therefore making them more robust and more likely to encourage the rules to evolve in a competitive manner. Accordingly, we submit that changing the guiding principles so they are more aligned with the GPS would not enhance either competition or consumer welfare.

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

No. We consider that the Commission has not given sufficient weight to the strength of the checks on the incentives for industry participants to exercise voting rights to prevent the introduction of pro-competitive rules. In particular, we believe that the Commission has failed to give sufficient weight to:

- the review role of the Auditor-General and the Parliamentary Commissioner for the Environment; and
- the threat of Crown intervention.

As the Commission is aware, the industry has worked extremely hard to create a rulebook which reflects the evolution of the industry to date and allows it to self-govern. Given the time, cost and effort expended by the industry to get to this point, was the authorisation granted we consider the industry would be extremely careful not to jeopardise its self governing regime. We are of the opinion that the Crown would intervene quickly if a pattern of anti-competitive voting emerged.

In our experience, system security issues raised and championed by the system operator have delayed pro-competitive developments, such as the introduction of combined cycle gas turbine technology. The system operator is required to protect the security of the system and will do so under both the proposed arrangements and the counterfactual in similar ways. In order to protect grid security, the system operator is incentivised to promote mandatory rules, which may delay or prevent pro-competitive developments.

A Crown EGB is likely to take an overly cautious, conservative and deferential (to the system operator) approach when considering new developments from a system security viewpoint whereas the voting arrangements under the proposed arrangement result in those parties whose rights are affected by developments being able to have a more appropriate involvement in the process via their voting entitlements. We believe that the system operator would have a degree of influence over a Crown EGB unmatched by the appropriate level of involvement of the remainder of the industry effected by the proposed development.

We further believe that the Rulebook gives greater scope for the passing of pro-competitive rule changes than the three existing codes as it applies a more comprehensive structure (given it contains an independent EGB, consumer and distribution companies with voting rights and working groups on which these groups are represented). With this in mind, we consider that the Commission has not given sufficient weight to the fact that there have only been two rules which have been voted down under the existing NZEM arrangements and neither of these were pro-competitive rule changes. In our view it is even less likely that pro-competitive rule changes will be voted down under the more comprehensive Rulebook.

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

We consider that the most likely circumstances in which participants would have a common interest in voting against recommended pro-competitive rule changes would be in relation to changes to Part G. Both the supply and demand side may, in our opinion, have a common interest in any change to those rules whether competitive or otherwise. However, for the reasons set out in relation to question 9, we do not consider it likely that pro-competitive rule changes will be voted down.

Under the counterfactual, a Crown EGB and the system operator would be likely to have a common interest in relation to any pro-competitive rule changes that might impact on transmission investment and system security issues, regardless of the effect on competition and the efficiencies relevant to those issues.

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

We are only aware of two NZEM rule changes that have been voted down. Neither could be categorised as a pro-competitive rule change.

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

By way of example under the NZEM, we note the passing of a rule changes in relation to real time dispatch and constrained on payments.

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

The Rulebook has been designed to provide for the rules to evolve as the industry evolves. In our view this is the best way to foster ongoing competition in an industry which is likely to continue to be subject to technological and resource developments. We believe that the Rulebook represents the evolution of the industry to date, reflecting a highly competitive and dynamic industry. It is possible that experience or industry advancements will show that the Rulebook could be improved to enhance competition. It is our belief that the Rulebook will evolve with that experience. However, without that experience, it is difficult to predict what rules have the potential to be changed to enhance competition.

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

We believe the voting arrangements represent a reasonable compromise position following extensive discussion by working groups on which consumers were represented.

***Question 15:*** *Under the counterfactual, would competition be likely to develop in the provision of administration, pricing and clearing services? Are there other service markets where competition would develop in the counterfactual, but not under the proposed arrangements?*

No. As the Commission has noted, there are two aspects to the contestability of service provision – first whether service provider roles are contestable through time, and second, whether the potential exists to bypass the service provider at any point in time.

We believe that contestability through time is likely to be greater under the proposed arrangements than under a Crown EGB. This is because the Crown EGB will be at a relative information disadvantage, and is therefore likely to have more difficulty specifying contract terms with external providers. It may also see internal provision as a means of enhancing its pool of technical knowledge.

In respect of bypass, the key issue is how easily either arrangement could be modified to allow such activity. In the proposed arrangements it would require that a rule change be suggested by a party, followed by a vote with requisite majority support. In the case of the counterfactual, it would require a change in regulations and/or rules promulgated by the Minister.

In both cases, those seeking scope for bypass would be expected to argue for that outcome. Any difference between the arrangements will come about because of the incentives and information possessed by the ultimate decision makers in each case. On balance, we believe that the proposed arrangements may be a little more likely to facilitate bypass than the counterfactual because:

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- bypass of its nature tends to bring more complexity and difficulty to the task of system operator. The arguments of the system operator are more likely to be heeded in the counterfactual because of the relationship it would have with a Crown EGB;
- to the extent that the Crown EGB does keep service provision in house, it will have an internal group with a potential direct stake in the outcome. Bypass may be seen as a threat by this group, providing an incentive for it to seek to block the change.

We do not believe there are any markets where competition would develop in the counterfactual but not under the proposed arrangements.

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

No. We believe a Crown EGB would adopt similar rules to the Rulebook, though we consider that the industry under a Crown EGB will evolve differently, and produce less efficient outcomes leading to a greater probability of inefficiencies over time.

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

No. We agree with the Commission's conclusion that these provisions, arising from MACQS, have been subject to extensive consultation and a Crown EGB would adopt the same, or very similar, rules. We consider that the rules provide certainty of standards to existing and potential market participants whilst allowing for applications to the system operator to allow other arrangements to be entered into. To that end they have the effect of enhancing competition as we consider that a Crown EGB would be less likely to encourage alternative arrangements than an Industry EGB as a Crown EGB would prefer uniformity of standards (under the influence of the system operator).

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

No. We agree with the Commission's conclusion that these are operational rules developed in the MARIA arrangements and a Crown EGB would adopt the same, or very similar, rules.

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

No. We repeat our comments in relation to question 18.

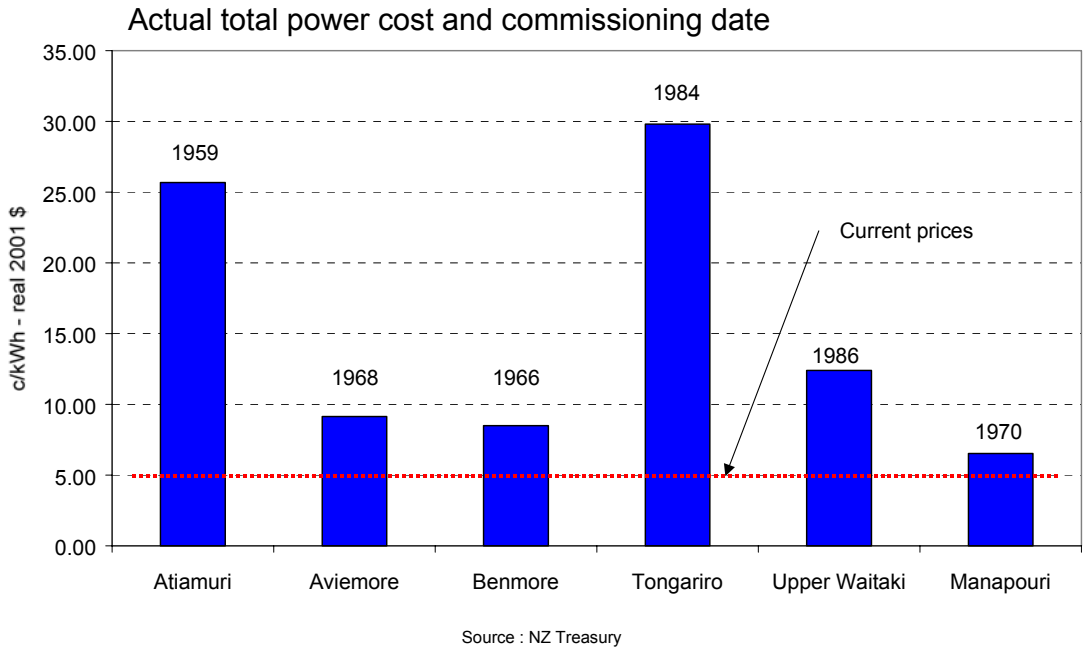
***Question 20:*** *What are the likely differences in ability and incentives between an Industry EGB and a Crown EGB to assess pricing methodologies, and what would be the benefits and detriments associated with any differences?*

We do not consider that there would be a material difference between the ability of an Industry EGB and a Crown EGB as we consider in each case that the industry will be charged with developing transmission service levels and pricing methodology. The role of the EGB is merely to assess whether the pricing methodology is consistent with the guiding principles, something we consider that a Crown or Industry EGB would be equally capable of doing. However, we note that a Crown EGB's task may be more difficult were it to adopt the GPS over the guiding principles as the guiding principles provide more certainty of application.

However, we do consider that the incentives of a Crown and Industry EGB will be different. A Crown EGB may be more focussed on political outcomes and will be subject to greater lobbying and influence by the Crown and the system operator. It is our view that this will result in a Crown EGB generally producing more conservative decisions than an Industry EGB.

While not directly applicable to the question being considered by the Commission, some illustration of the importance of information and incentives can be gained by examining the performance of the electricity generation industry in the period when it was managed directly by the government.

The NZ Treasury carried out a study in 1985 to assess its performance and concluded that the inefficiencies inherent in the centralised planning and procurement process were large enough to have economy wide implications. Among the problems that were apparent were projects being advanced before they were necessary (over-investment) and pursuing projects in an order that did not reflect economic efficiency (i.e. lowest cost first). This is illustrated in the chart below which presents data from the Treasury study in 2001 money terms.




Whilst the poor performance evident at that time reflects a combination of factors, we believe that at least part of the explanation lies in the fact that considerations other than economic efficiency played a significant role in decision making.

We consider that there is a greater risk of a Crown EGB putting greater emphasis on issues raised by the system operator, resulting in a skewed analysis of pricing issues by a Crown EGB. We believe that there would be an incentive on parties to adopt polar positions under a Crown EGB in order to work back to a middle ground on the basis that the result will be a more political outcome. Because of this, we consider a Crown EGB would give rise to a more adversarial process and a greater amount of lobbying, leading to a more drawn-out process.

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

We do not consider that there should be a material difference between an Industry and Crown EGB on this issue.

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

We agree with the Commission's statement of the counterfactual in paragraph 320 but not in paragraph 321. The Commission states in paragraph 321 that the Industry EGB would have to rely

on quantum meruit to enforce charges. We consider that most charges would be enforced under normal contractual laws as all parties to the arrangement using transmission services will be bound by the pricing methodology contained within Section III of Part F.

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

We agree that a Crown EGB would be incentivised to over-invest in transmission to avoid the adverse consequences it would face from a grid failure, particularly as it would not have to fund transmission investment (except for its transaction costs). We believe a Crown EGB's incentive to approve over-investment (on behalf of the Crown) with costs allocated by regulation would result in a significant disincentive to private transmission competition and investment. This we believe would lead to inefficiencies growing over time. We refer to our comments on Crown EGB decision making in relation to other questions.

We do not consider that the proposed arrangements will be likely to result in under-investment in transmission. The Commission seems to have placed weight on the fact that lines companies will hold the majority of votes in relation to new investment. Whilst this is a possibility, the coalition aspect of the rules pertaining to new investment allows for any interested party to form with other parties a coalition in support of an investment.

Whilst there will be transaction costs of forming a coalition, we consider that these should be more than offset by the potential benefits of worthwhile new investments. We believe a Crown EGB would also face significant transaction costs. A Crown EGB would we believe face the cost of gathering information as to what investment is necessary and how it can best be delivered and paid for. Despite taking consultative steps to gather information, we believe a Crown EGB would have less chance than an Industry EGB (or a coalition of interested parties) of obtaining the best information. The temptation to take 'polarised" positions would also arise in these circumstances under the counterfactual as parties try to encourage a political compromise.

We also note that Section II of Part F provides for a binding contract to be formed meaning that the transmission provider would contract for charges arising out of new investment. In our view, the transmission provider would only have to rely on quantum meruit where it decided to invest in new transmission without the support of the industry i.e. if it invested in a services which nobody wants.

We consider that, when voting on transmission investments participants will be mindful of the fact that any failure to approve efficient investment in the grid will be likely to result in Crown intervention, whether via the Commerce Commission or an action by the Minister under the EAA. This is a significant incentive on participants to approve efficient investment.

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

Whist we agree that a Crown EGB would have a similar level of institutional competence to assess proposed pricing methodologies, we consider that there is a risk that a Crown EGB may be influenced (politically) to take a less critical view of a methodology proposed by the system operator. This could result in a pricing methodology skewed towards the system operator. This perceived risk would encourage an adversarial/polarised process. We refer to our comments in relation to questions 20 and 21.

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

No. We believe the proposed arrangement and the counterfactual will result in a similar level of competition as the rules adopted in the counterfactual would be similar to those in Part G. For the reasons set out in relation to question 15, we consider that the level of competition would be similar in relation to administration, pricing and clearing services.

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

No. We agree with the Commission's conclusions in paragraph 347.

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

No. We agree with the Commission's conclusions in paragraph 352 but note that concern has been raised in other submissions that the granting of dispensations under the Rulebook favours existing industry Participants over new entrants. It is our view that this is not the case. In particular we note that the dispensation regime under the Rulebook is available to all participants (new or existing), is transparent and the standards are open to review under the Part A and C rules.

***Question 28:*** *Notwithstanding the Commission's usual approach of not counting changes in the distribution of income either as a benefit or detriment, having regard to the principles of the GPS which emphasise the well-being of consumers, is there a case in this instance for recognising transfers from consumers to producers in this assessment of detriments? If so, what weight should be given to this factor when assessing detriments against benefits?*

No. We agree that the Commission must, in accordance with section 26 of the Act, have regard to the economic policies transmitted to it by the Crown. However, the Commission, like the courts, uses

established economic principles in assessing whether benefits outweigh detriments in any given case. These economic principles provide some level of objectivity to the assessment. We do not consider that the Commission should interpret the GPS (in this or any other case) as providing it with scope to overturn those accepted economic principles. We believe that it would set a bad precedent for future applications and even the remainder of the present application as the applicant and interested parties may wish to assess whether the GPS indicates that other economic principles should be overturned.

In terms of future applications in which the Crown is interested, it may also result in the Crown being incentivised to issue GPS giving a strong indication of factors important to it. This would identify to the Commission those factors in relation to which the Crown wishes the Commission to ignore economic principles and view those factors as either a benefit or detriment.

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

We note at the outset our view in relation to Question 8 that the GPS and the guiding principles are broadly consistent with each other. On that basis we consider that the GPS will have a similar influence on each EGB.

However, to the extent that there is a subtle difference in the manner in which each EGB would be influenced, we agree with the Commission's reasoning. In the absence of a strong direction from the Crown, an Industry EGB would be more likely than a Crown EGB to prioritise work-streams giving rise to economic benefits. This is based on our view that a Crown EGB would contain political appointees, at least some of who would have a lesser focus on economic issues than appointees to an Industry EGB. We note also that an Industry EGB would be subject to stronger influence from forces other than the Crown.

In our view, a Crown EGB would be more beholden to ongoing political influence than an Industry EGB, including via the issue of subsequent government policy statements, although an Industry EGB will be highly likely to adopt rules to address any strong statement of government policy in order to avoid any formal Crown intervention. We believe that a Crown EGB would be more likely to get involved in micro-management of issues which it perceived as important issues to the Crown.

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

We consider that a Crown EGB will be more likely to accommodate short term political pressures at the expense of economic efficiency. This would tend to result in ongoing uncertainty in the industry,

increased cost of capital due to regulatory risk, and significant lobbying and other costs arising each time a change is proposed.

A Crown EGB's greater focus on non-economic issues may lead to increased cost of compliance/business for industry participants. Micro-management of key issues arising from government policy by a Crown EGB could result in the Minister, via a Crown EGB, becoming progressively more involved in operational matters.

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

We agree that an Industry EGB would be more competent in assessing rule changes and decision-making than a Crown EGB. However, as noted in relation to question 9 we believe that the Commission has over-stated the potential and likelihood for manipulation of the Rulebook given the extensive checks and balances in the proposed arrangements. Given that the Commission has, we think correctly, concluded that there are sufficient checks and balances to prevent the passing of anti-competitive rules, the Commission's concern in this regard is again its perception that generator-retailers may be able to veto pro-competitive rules. We refer the Commission to our comments on question 9 in this regard.

We believe that under the counterfactual the Minister would hold a great deal of influence over the Crown EGB, giving rise to the risk of political objectives overriding efficient decisions or pushing through inefficient decisions. Again, we note that under a Crown EGB, industry participants are more likely to take polar positions on issues, resulting in a more drawn out decision-making process. The Minister and Crown EGB are unlikely to be as well-informed as the industry. The Minister and Crown EGB may also be more heavily influenced by lobbying by the system operator with whom they share grid security risk.

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

We do not consider that there are other markets where the proposed arrangements are likely to have a material impact on public benefits and detriments.

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

We believe that the cost of capital would be higher in the counterfactual. We disagree with the Commission's assessment in paragraphs 410 to 412.

We agree that the risk of Crown intervention exists under the proposed arrangements (and believe the threat of such intervention will constrain anti-competitive behaviour). However, we believe that the risk of more frequent and more wide ranging intervention is inherent in the counterfactual, resulting in a higher cost of capital in the counterfactual. The fact that the industry would shift from self-governance (with the threat of intervention) to Crown-governance, immediately implies a greater level of risk of Crown intervention. In our view this implication would be borne out in that, as noted in the counterfactual, the Crown EGB would refer certain issues to the Minister.

The Crown would also have a more traditional and accepted route to impose regulation on the industry in the counterfactual as the industry would already be governed by regulations. In that situation, it may be viewed as politically more acceptable for the Crown to intervene in the industry. In our opinion the capital markets would consider this as heightening the risk of future intervention. We believe the capital markets would also consider Crown decision-making (rightly or wrongly) to be less informed, less focussed on financial and economic issues, and less flexible, adding further to the cost of capital under the counterfactual.

We also believe that the focus on Contact and Trustpower downplays the significance of cost of capital issues to the SOE's. The Crown has in recent times allowed Terralink, an SOE, to fail. We do not consider that there is an implied guarantee of SOE's by the Crown. We are also aware that SOE's have separate credit-ratings to the Crown, implying that they have a different level of credit risk and therefore a different cost of capital.

The Commission has also not taken into account the cost of capital to other market participants such as NGC, Todd Energy, and other private participants in the market..

In summary, in our view the Commission has under-stated the difference in the cost of capital in the counterfactual relative to the proposed arrangements.

***Question 34:*** *Would regulatory risk only affect the cost of capital for private sector interests, or would it also affect the cost of capital for SOE's?*

No. We refer to our comments under question 33.

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

The potential for transmission over-investment, regulatory capture, micro-management, greater regulatory risk and less informed and slower decision making would lead to productive and dynamic inefficiencies developing in the generation and service provider markets. We consider the Commission should place greater weight on these inefficiencies as detriments.

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

Yes. We agree with the Commission's conclusions that a Crown EGB would be subject to greater political influence and greater lobbying whilst being less well-informed. The informational difference and political influence would impact adversely on the quality of decision-making and the difference in lobbying would impact adversely on the speed of decision-making.

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

Yes.

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

We consider that a Crown EGB would result in parties taking polarised positions to lobby the EGB and the Minister on issues of importance. We believe lobbying the members of a Crown EGB and the Minister would become important parts of any decision-making process, adding expense and time to the process. We consider that the cost of Ministerial advice should also be considered as part of the lobbying cost.

***Question 39:*** *Would a Crown EGB be likely to make decisions that result in over-investment in the grid?*

Yes. We consider that a Crown EGB would be likely to take an overly risk-averse approach to avoiding the consequences of a grid failure (for which the Crown would politically be responsible), particularly as a Crown EGB could allocate the cost of such decisions by regulation.

***Question 40:*** *Would industry input into a Crown EGB's investment decisions provide a restraint on the potential for over-investment and over-maintenance of the grid?*

We believe lobbying by industry is unlikely to be a sufficient counterweight to overcome the Crown's unease at being responsible for a perceived grid failure. The costs of over-investment and over-maintenance, while potentially significant in total magnitude, would be spread thinly over many parties. A Crown EGB would weigh this cost against the very visible 'costs' associated with a failure. The political risk of a grid failure would, in our opinion, be the paramount concern.

We would also note that under a Crown EGB, because there is direct government involvement, there would be less incentive on transmission providers and purchasers to cooperate to find solutions to problems. Once an agent of government is involved, it is much more likely that parties will assume and defend 'polar' positions, in the belief that the final 'political' outcome will be some form of compromise between the respective positions.

***Question 41:*** *Is the Commission's assessment of the likelihood of contestable services under the proposed arrangements and in the counterfactual appropriate?*

We refer to our answer to question 15.

***Question 42:*** *Are there examples from other industries of the magnitude of benefits available through making services contestable?*

We are not aware of any studies that deal with the specific issue under consideration.

***Question 43:*** *In addition to making service provider roles contestable, would efficiency gains from an ability to bypass service providers have a material impact on net benefits?*

It is difficult to predict the scope of potential net benefits from bypass. However, we would note that the possibility of bypass exists under either arrangement. The key issue is the likelihood that desirable bypass will occur in each.

For the reasons noted in question 15, we believe bypass may be more likely in the proposed arrangements.

***Question 44:*** *What scope is there for the proposed arrangements to change over time to remove or lower entry barriers or improve efficiency in the relevant markets?*

We see no obvious scope at this stage to amend the proposed arrangements to remove or lower barriers or materially improve efficiency in the relevant markets.

However, as we have already noted, the strength of industry self-governance in the past, and one of the strengths of the proposed arrangements is the fact that the rules are able to evolve with experience, changes in technology or the environment in which the industry operates. For this reason, we believe that future developments in the industry will give rise to scope for the proposed arrangements to change over time to remove or lower entry barriers or improve efficiency.

***Question 44 (there are two question 44's):*** *What are the incentives on distributors to vote on reduction or elimination of grid constraints?*

As the Commission has already observed, distribution companies tend to derive a significant portion of their revenue from variable charges. As a consequence, their revenue is lowered to the extent that constraints reduce the quantum of energy they transport. This provides distributors with an incentive to alleviate constraints, which if left unrelieved could reduce a network's expected sales volume.

More generally, we are not aware of any reason why networks would oppose a transmission upgrade that would have the effect of lowering the overall cost of delivered energy excluding distribution charges (i.e. energy plus losses plus transmission) in their service area. This is because, other things being equal, over time load will tend to grow faster in areas with lower relative total energy costs.

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

As noted above, we believe that, in general, distributors have an incentive to alleviate all types of constraints, where the expected benefits of doing so outweigh the expected costs.

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

Fundamental to the draft determination's conclusion is a view that generator-retailers can and will block pro-competitive rule changes, and that under investment will occur in the transmission grid. As set out above, we believe that these conclusions are not sound.

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

As noted above, we do not believe the detriments would arise in practice.

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

We consider that the Commission has carried out a reasonably comprehensive review of the relevant issues in the draft determination. However, as noted in our answers to other questions, we believe the Commission has not always given appropriate weight to some of the matters it has reviewed.

***Question 49:*** *If the Commission chose to authorise the proposed arrangements, what condition(s) on the authorisation would address concerns about the potential for pro-competitive rule changes not being implemented?*

We do not believe any conditions are necessary as we consider that the Commission has overstated the potential for pro-competitive rule changes to be vetoed, and the likelihood of under-investment in the transmission network.

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

Not applicable.

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

We do not believe that any conditions are necessary.

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

Many of the benefits from the arrangement relative to the counterfactual are long term in nature (e.g. efficiency of utilisation of transmission assets). In that context, use of a ten year period appears rather short.

Though not strictly related to the assessment period, there is one other important issue we should note. The draft determination has assumed that any detriments from blocking pro-competitive rule changes or transmission investments will be ongoing in nature. As noted earlier, we do not believe

that the government would stand idle if there was evidence of this occurring. We would expect such detriments to persist for only 1-2 years.

***Question 53:*** *Are the Commission's assumptions on the magnitude of efficiency gains arising from the comparative advantage of industry decision-making relative to the counterfactual appropriate?*

While we are not in a position to make detailed comment on this issue, we are not sure why the Commission uses an estimate of 'production cost' for measuring the benefits of productivity growth rather than market value of output.

***Question 54:*** *Are the Commission's estimates of the higher transaction costs in the counterfactual of an appropriate order of magnitude?*

While we are not in a position to make detailed comment on this issue, we note our observation of arrangements in other countries would tend to suggest that lobbying costs would increase significantly under the counterfactual – the estimated cost of $ 0.6-1.2 million per annum appears relatively low.

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

While we are not in a position to make detailed comment on this issue, we would offer the following broad observations:

- we would expect the main detriments of the counterfactual in transmission to be felt through unnecessary or premature transmission investment. This is because investment (rather than maintenance) deals more directly with the political risk of grid constraints.
- in that context, the productive inefficiency assumption looks relatively conservative – only 0.5 - 1% per annum.

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

While we are not in a position to make detailed comment on this issue, we would offer the following broad observations:

- the assumed differences in productivity of service provider arrangements appear relatively low. They seem to imply that contestability is similar in the proposed arrangements and the counterfactual, or that there is little to be gained from contestability. The former contention is at

odds with other comments in the draft determination, and the latter is inconsistent with experience;
- we think it less likely that service provider roles will be contestable in the counterfactual.

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

As noted above, we believe that the proposed arrangements are more likely to see the roles of service providers and system operator made contestable.

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

As noted elsewhere, we believe do not believe that pro-competitive rule changes would be blocked by generator-retailers in the new arrangements. We therefore do not believe that prices would be higher under the proposed arrangements relative to the counterfactual.

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

We are not in a position to comment at this time.

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

Please refer to answer to question 58.

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

Please refer to answer to question 58.

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

As noted elsewhere, we do not believe that the proposed arrangements will lead to under-investment in transmission assets.

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

Please refer to the answer to question 62.

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

Please refer to the answer to question 62.