

**COMMERCE COMMISSION
AUTHORISATION APPLICATION
FOR ELECTRICITY MARKET
ARRANGEMENT**

COMMERCE ACT 1986: RESTRICTIVE TRADE PRACTICE
SECTION 58: APPLICATION FOR AUTHORISATION

Date: 6 December 2001

The Registrar
Business Acquisitions and Authorisations
Commerce Commission
P O Box 2351
WELLINGTON

An application for **authorisation** of a restrictive trade practice is hereby made in terms of section 58 of the Commerce Act 1986 by:

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The Applicant attaches as Appendix F the form of application for authorisation of a restrictive trade practice.

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INTRODUCTION

1. INTRODUCTION

- 1.1 This application relates to a proposed arrangement between players in the electricity industry which might include practices of the kind described in section 58 of the Commerce Act 1986 ("Act"). The arrangement will restructure the basis under which the industry trades electricity by combining various existing market arrangements and integrating new arrangements into a single rulebook ("**Rulebook**") and implementing various supporting agreements (collectively the "**Arrangement**").
- 1.2 The new Arrangement represents the outcome of lengthy discussions between industry players, including consumers, in response to the Government's requirement that the industry develop a contractual arrangement of its own making or face regulation. The industry believes that the Arrangement will enhance the operation of the electricity sector.
- 1.3 This application includes:
- (a) An explanation of the background to the proposed Arrangement in sections 2 to 4, including the history of the electricity industry, an explanation of how the market currently works and a discussion of the reform process that has been undertaken throughout 2000 and 2001;
 - (b) An explanation of the application in sections 5 to 10, including the identity of the applicant (Electricity Governance Board Limited), the scope of the authorisation sought and an indication of the likely affected parties;
 - (c) A discussion of the proposed Arrangement in sections 11 to 14, including an overview of the Rulebook and an explanation of the object and effect of each of the operative parts of the Rulebook;
 - (d) A discussion of the relevant markets, the counterfactual and the relevant provisions of Part II of the Act in sections 15 to 21;
 - (e) An analysis of individual characteristics of the Arrangement to which the authorisation relates in sections 22 to 30; and
 - (f) An analysis of the net public benefits of the arrangement in sections 31 and 32.

BACKGROUND TO PROPOSED ARRANGEMENTS

2. HISTORY OF THE ELECTRICITY INDUSTRY

- 2.1 Regulatory reform in the electricity industry commenced in the mid 1980s (for more information see Background Paper, "Evolution of the Electricity Industry", Folder of Supporting Material, number 1). At that time, the Ministry of Energy was responsible for both the generation and transmission of electricity. The initial reforms separated the operating parts of the Government's energy assets from its policy function and were aimed at strengthening the accountability and commercial focus of the new operations companies and promoting competition in the electricity industry ("Chronology of New Zealand Electricity Reform", Energy Markets Policy Group, Ministry of Economic Development, February 2001, Folder of Supporting Material, number 2).
- 2.2 The Electricity Corporation of New Zealand ("**ECNZ**") was established in April 1987 as a state-owned enterprise to own and operate the generation and transmission assets of the Ministry of Energy. In April 1988, there was a move towards separating ECNZ's functional elements when Transpower New Zealand Limited ("**Transpower**") was established as a subsidiary of ECNZ with responsibility for operating the transmission network. ECNZ retained its core business of generation.
- 2.3 The Ministry of Energy was abolished at the end of 1989, with the Ministry of Commerce (now the Ministry of Economic Development) adopting the majority of the remaining roles of the Ministry of Energy.
- 2.4 Subsequent reform continued as follows:
- (a) The Government announced in May 1990 that the electricity supply authorities would be corporatised;
 - (b) An establishment board was set up in July 1990 to oversee the commercial separation of Transpower from ECNZ, with the intention that Transpower be owned by a club of distributors and generators; and
 - (c) The Electric Power Boards Amendment Act 1990 was passed in August 1990, and provided for commercial directors to be appointed to Electric Power Boards by the Government, from October 1990. The Electric Power Boards were corporatised pursuant to the Energy Companies Act 1992 and became

owned predominantly by trusts and local authorities, although majority private shareholding resulted in some cases.

- 2.5 The water shortage and subsequent electricity crisis in 1992 was a spur to further reform. In addition, some private interests were concerned that the creation of a wholesale market had been given less attention than distribution and retailing. The private sector released a study which recommended a major evolution of existing market arrangements to provide a predictable price path for wholesale electricity, to enable some trading at marginal prices, and to allow competition with ECNZ. A Government report in 1993 recommended establishment of the ground rules of market operation, with the threat of heavier regulatory oversight.
- 2.6 A further development was the Electricity Act 1992 which came into force in April 1993. This Act provided for, amongst other things:
- (a) Deregulation of distributors' statutory monopolies;
 - (b) Information disclosure requirements, particularly imposing requirements on natural monopolies (this occurred in July 1994 when the Information Disclosure Regulations were promulgated);
 - (c) Temporary provision for price control for domestic consumers; and
 - (d) Compulsory maintenance of line services until 2013.
- 2.7 The removal of statutory distribution and retail monopolies allowed competition for sales to retail consumers.
- 2.8 In May 1993 the Government announced the separation of Transpower from ECNZ. In July 1994, Transpower became a separate state-owned enterprise.
- 2.9 Meanwhile, in June 1993 the Government had established the Wholesale Electricity Market Development Group.. The terms of reference for the Group included the development of specific, cost effective proposals for developing a wholesale electricity market that, consistent with sustainable development, would ensure that wholesale electricity is delivered at the lowest cost to the economy. In 1993 the Electricity Market Company Limited (now The Marketplace Company Limited, "**M-co**") was set up by ECNZ and the Electricity Supply Association, to develop an electricity market framework for wholesale trading, including:
- (a) Commencement of an on-line secondary market in trading in ECNZ's hedge contracts;

- (b) Establishment of a market surveillance committee to admit new entrants and supervise conduct; and
 - (c) Administration of the Metering and Reconciliation Information Agreement ("**MARIA**") to record and reconcile flows to assist contracting parties in the wholesale and retail markets.
- 2.10 In July 1995 the Government announced that in the lead up to the opening of a wholesale electricity market it would:
- (a) split ECNZ into two competing state-owned enterprises: ECNZ and Contact Energy;
 - (b) sell six small hydro plants owned by ECNZ; and
 - (c) impose special constraints on ECNZ until its market share fell to 45%, including a cap on the building of new capacity, ring-fencing new capacity, and a high level of firm capacity to be offered by tender for long-term contracts.
- 2.11 Contact Energy commenced operations as a state-owned enterprise generator, in competition with ECNZ in February 1996. Contact took over several power stations formerly belonging to ECNZ, representing 22% of total energy production, as well as ECNZ's Maui gas contracts.
- 2.12 In October 1996 the wholesale electricity market (the New Zealand Electricity Market, "**NZEM**") commenced operations, with M-co acting as market administrator, clearing manager and pricing manager, while Transpower acted as grid operator, dispatcher, scheduler, and reconciliation manager. An electricity market was necessary because there were now two generators competing to supply electricity.
- 2.13 In 1997 Transpower established the Interim Grid Security Committee to review the setting and maintenance of grid security standards.. This resulted in the establishment of the Grid Security Committee in November 1999 following authorisation by the Commerce Commission of the Multilateral Agreement on Common Quality Standards ("**MACQS**"). MACQS established a process to agree rules to allow standards to be set for common quality, including security, a contractual structure for implementing agreed common quality standards, and a robust monitoring, compliance and dispute resolution process.
- 2.14 Subsequent reform focussed on the separation of monopoly aspects of the industry to remove opportunities for cross-subsidisation between contestable and non-contestable

parts of the industry and encourage competition in contestable areas. At the same time, regulatory controls over monopolies were strengthened. In particular::

- (a) The Electricity Industry Reform Act 1998 was enacted on 8 July 1998. This Act provided for corporate separation of lines and energy businesses by 1 April 1999, and full ownership separation no later than 31 December 2003. In the end, commercial drivers meant that ownership separation of line and supply businesses was completed by 1 April 1999;
- (b) In March 1999, the Government sold 40% of Contact Energy to Edison Mission Energy. The remaining 60% was offered to the public in May 1999;
- (c) ECNZ was split into three competing state-owned generators, Genesis Power Limited, Meridian Energy Limited and Mighty River Power Limited, which commenced trading on 1 April 1999;
- (d) The electricity industry included a profiling system in MARIA, allowing non half-hour meter consumers to switch retailers. This system is now administered by M-co; and
- (e) The Electricity (Information Disclosure) Regulations 1999 came into force, replacing the 1994 regulations. The new regulations removed disclosure requirements from retailers and generators, introduced new measures of reliability performance, tightened rules for accounting, required line owners to disclose asset management plans and security standards, and provided for much of the disclosed information to be made available on the internet.

3. CURRENT MARKET OPERATION

Introduction

3.1 Contracts for the demand and supply of electricity are established through two main inter-connected arrangements:

- (a) The New Zealand Electricity Market ("**NZEM**"), which is a multilateral contract through which most wholesale electricity is bought and sold; and
- (b) MARIA (Metering and Reconciliation Information Agreement), which provides rules for the creation of bilateral contracts for the sale and purchase of electricity.

- 3.2 In addition, MACQS (Multilateral Agreement on Common Quality Standards) is an industry agreement for the creation of common quality standards in the industry, primarily in relation to frequency and voltage.

NZEM

- 3.3 The wholesale electricity market, or NZEM, is the multilateral trading arrangement where most wholesale electricity sales are transacted. NZEM was initially established in 1994 to trade electricity hedge contracts. In 1996 a full wholesale market was established, based on a multilateral contract between industry players. NZEM is intended as a mechanism to match the supply and demand for electricity and to establish or "discover" the wholesale price of electricity. The price signals that the market provides send important investment signals for generation and transmission, and create the opportunity for purchasers and consumers to better manage their consumption of electricity.
- 3.4 NZEM is a voluntary market that operates within a code of practice known as the Rules of NZEM ("**NZEM rules**"). These were developed through a process of consultation and voting by industry players. The NZEM rules cover every aspect of trading, from entry criteria to physical electricity dispatch. They also include procedures for financially settling transactions between market players buying and selling electricity on the spot market, and procedures for receiving bids and offers.
- 3.5 Buying and selling electricity at a wholesale level is accomplished using a "pool", where electricity generators offer electricity to the marketplace. Purchasers then buy electricity from the "pool" to supply their customers. Under NZEM a price is established for each 48 half hour trading period every day at approximately 250 grid connection points around New Zealand. The price at each of these points incorporates the cost variation of electricity transmission owing to location, system security, and constraints. It also sends strong investment signals to members of NZEM. The underlying price is set by the intersection of the actual demand and supply curves. Electricity is priced at market clearing levels and the price is allowed to rise and fall without restriction in response to supply and demand.
- 3.6 Although the electricity market administered by NZEM is commonly referred to as a "spot" market, in fact it is not such a market. Rather it is a contract market, a mechanism that seeks to mimic a commodity spot market. It involves an agreed, programmed process for the matching of buyers and sellers and for the formation of a "spot" price. This approach is common in electricity "spot markets" (Market Surveillance Committee memorandum to the New Zealand Electricity Market, 17 July 2001).

- 3.7 Market players may manage their risk by entering into financial risk management contracts, which are usually contracts for difference. Such financial arrangements are not subject to any of the rules governing the electricity industry.

MARIA

- 3.8 MARIA was established in 1994 to reconcile the quantities of electricity traded bilaterally through the national grid. MARIA was initially established as an arrangement to allow competition for commercial and industrial consumers. Its focus was on specifying metering and reconciliation standards to facilitate choice for those consumers. However, MARIA's scope has since broadened. MARIA now aims to ensure all electricity consumers, including domestic households, are able to change their electricity retailer with ease. The prime focus of MARIA is creating an environment that enables competition amongst retailers to supply electricity consumers through effective, fair and efficient electricity trading arrangements. Additionally, MARIA matches the quantities of electricity supplied to customers by retailers with the contracts for supply which the same retailers have with generators.
- 3.9 Retail competition in the electricity industry was made possible by introducing a new system linking prices paid by consumers and prices paid by retailers - this system is called "profiling". Essentially profiling estimates a consumer's half-hourly electricity consumption by looking at their average consumption at different times (their "profile"). Profiling establishes an agreed half hourly consumption pattern for each consumer, thereby enabling a retailer to sell electricity to any consumer anywhere in the country.
- 3.10 A national database, the Registry, is at the centre of the system that profiles all 1.5 million electricity consumers in New Zealand. It identifies every electrical installation (or premises) by a unique number, an Installation Control Point ("**ICP**"). ICPs are printed on the consumer's monthly power bill and is the reference for switching electricity retailers.
- 3.11 The MARIA rules also provide the standards for meters that measure electricity use. In addition, the rules determine the metering standards a new retailer must meet before it can take over supply to an individual consumer.
- 3.12 The MARIA rules require all parties to provide certain data so electricity flows can be reconciled. The MARIA reconciliation arrangement then matches the quantities bought with the quantities sold for each contract. It also determines any mismatch not covered by contracts and the basis for settlement of any mismatches with NZEM, including those due to transmission losses and constraints. The MARIA rules impose a self-regulating structure with mechanisms for selecting a governance board, making rule changes, resolving disputes and enforcing rules.

MACQS

- 3.13 In addition to the NZEM and MARIA codes, the industry has agreed to MACQS (Multilateral Agreement on Common Quality Standards), which sets out a process for agreeing rules to allow standards to be set for common quality of electricity transported across the national grid. Following the authorisation of MACQS and its associated contractual arrangements by the Commission in Decision 369, the governance arrangement for MACQS was established. Minor modifications to MACQS have been made by the GSC (which were the subject of correspondence with the Commission in June 2000).
- 3.14 Rules have been developed pursuant to MACQS to move the electricity industry to a self-regulating structure that determines common quality (including security) standards for electricity supply. MACQS aims to transfer the responsibility for supply quality from Transpower to the industry. The common quality rules under which the industry currently operates are contained in the grid operating security policy.
- 3.15 MACQS establishes the processes for parties to reach agreement and secure the provision of common quality of electricity. Common quality primarily relates to the voltage and frequency levels on the core grid. The rules for common quality were established by the industry through participation in working groups convened by the Grid Security Committee ("**GSC**"). These rules have taken over three years to develop. These rules have not yet been implemented, because they have been incorporated into the Rulebook and will take effect when the Rulebook takes effect.

4. REFORM PROPOSALS 2000 / 2001

- 4.1 The genesis of the proposed Arrangement lies in two sources:
- (a) The stated desire of the present Government to see a defined set of improvements to market governance and design, and to rationalise the three existing codes, NZEM, MARIA and MACQS (Government Policy Statement, December 2000, Folder of Supporting Material, number 7); and
 - (b) The industry's own desire to improve governance and market design. Even before the establishment of the Electricity Governance Establishment Project ("**EGEP**", see paragraph 4.9), the industry had been actively pursuing an amalgamation of NZEM and MARIA under a project known as NZEX. Additionally, the industry had initiated work on designing operational rules for the MACQS arrangement and developing the interface between NZEX and MACQS.

- 4.2 On 3 February 2000, the Minister of Energy, Mr Peter Hodgson, announced the terms of reference for a Ministerial Inquiry into the electricity industry, which was to evaluate whether the current regulatory regime met the Government's objective of ensuring electricity is delivered in an efficient, reliable and environmentally sustainable manner to all classes of consumer. The Inquiry was instructed to focus on distribution and retailing, the wholesale market and the transmission grid. The Inquiry was asked, if it found that the current arrangements did not achieve the Government's objectives, to make recommendations for any amendments to policy and the regulatory framework that would assist in achieving those objectives.
- 4.3 The Inquiry reported to the Minister of Energy on 12 June 2000 (Report to the Minister of Energy on the Inquiry into the Electricity Industry, Folder of Supporting Material, number 6). The Minister noted that the Inquiry panel recommended a comprehensive and principle driven approach to improving the efficiency and fairness of the electricity market. The Inquiry panel recommended further evolution of the self-regulatory arrangements in the electricity industry as well as a credible threat of price control for electricity lines businesses. Another recommendation of the Inquiry, was that there should be a clearer distinction between the financial and physical wholesale markets. The Inquiry noted that the financial market did not need a special framework as disciplines existed for the financial markets in general and these would be adequate for this purpose. The physical market, on the other hand, would need a governance structure.
- 4.4 The Inquiry recommended that the Government should invite the industry to put its proposed new governance structure in place within a maximum of 12 months. If the industry failed to commit to creating a new governance structure, the Government should legislate and create the regulatory environment to achieve the recommended single governance structure.
- 4.5 The Inquiry's recommendations were subsequently incorporated into Government policy as transmitted in the Government Policy Statement ("**GPS**"), issued under section 26 of the Commerce Act. The GPS, released on 7 December 2000, reflected the issues identified in the Inquiry. In that statement the Government indicated that it wished to see further evolution of self-regulatory arrangements and that it favoured industry solutions where possible. The GPS set out the Government's expectations for industry action and its views on governance matters. These include:
- (a) Establishing a new governance structure for New Zealand's electricity market with the establishment of a single electricity governance board to replace the existing three governance arrangements for NZEM, MARIA and MACQS. The

new structure will also include rules relating to transmission and elements of distribution;

- (b) Ensuring Transpower's pricing methodology conforms to the objectives and principles for the provision of transmission services, and that Transpower and its customers comply with the pricing methodology;
- (c) Compliance with the rules developed under the supervision of the governance body being compulsory for generators, distributors, retailers, directly connected end users and Transpower, to the extent that they are applicable to these parties;
- (d) The governance framework not precluding the establishment of competing arrangements consistent with unified security constrained dispatch and the GPS;
- (e) The development of financial instruments, such as financial transmission rights for industry players to better manage risk in respect of transmission losses and constraints; and
- (f) A consumer complaints resolution system being established in consultation with the Ministry of Consumer Affairs.

4.6 Before the Government announced the Inquiry, the industry itself had identified the need for rationalisation of the structures surrounding the industry. In 1999 the NZEM Rules Committee and the MARIA Governance Board, in consultation with the industry, agreed to pursue further efficiencies by rationalising the two structures.

4.7 Work on this new structure, the NZEX project, commenced towards the end of 1999 and continued into 2000 until overtaken by EGEP. Its purpose had been to achieve a common governance structure for the two existing multilateral trading arrangements, NZEM and MARIA, and to improve the existing codes. The chief objective in doing so was to capture efficiencies by reducing duplication in governance costs. Until overtaken by EGEP, this process had advanced to the stage of a combined rulebook being developed and put to consultation with the industry. The NZEX project did not deal with common quality issues. That remained the domain of MACQS. Work had been undertaken, however, on harmonising the co-existence of the two codes.

4.8 The industry chose not to bring the NZEX project to fruition in favour of moving towards a single combined rulebook that integrated trading and common quality rules as well as some of the other additional aspects specified in the GPS. MACQS became operational

in a governance sense at the end of 1999, when detailed operational rules were developed to govern common quality. However, the operational MACQS rules have never come into effect. They were due to come into effect at the end of 2000, but it was decided to postpone this and incorporate these rules into the proposed combined Rulebook.

- 4.9 EGEP commenced in October 2000 in response to the first draft of the GPS issued on 3 October 2000. The first step in this project was the establishment of the Electricity Governance Establishment Committee ("**EGEC**"). EGEC is an oversight body comprising representatives of each of the industry areas that will be covered by the Electricity Governance Board (see paragraph 13.15). Members of EGEC have been drawn from the existing industry governance structures (MACQS, MARIA and NZEM) and from other key stakeholders. The Government stressed the need for end-use consumers to be represented and this is reflected in the composition of EGEC as follows:

Member of EGEC	Body represented
David Caygill (Chair)	Grid Security Committee
Catherine Petrey	Consumer Coalition on Energy
Martin Walton	MARIA Governance Board
George Riddell	Consumer Coalition on Energy
Richard Rowley	MARIA Governance Board
Toby Stevenson	NZEM Rules Committee
Ken Forrest	Network companies
Keith Tempest	NZEM Rules Committee
Bob Thomson	Transpower
Keith Turner	Grid Security Committee

- 4.10 The role of EGEC is:

- (a) to achieve an agreed industry governance arrangement based on a multilateral contract; and

- (b) to act as the project oversight committee until such time as the new Electricity Governance Board is able to assume that role.
- 4.11 EGEC has reported to the Minister of Energy on a two-monthly basis on the progress of EGEP and its alignment with the outcomes specified in the GPS.
- 4.12 Although the Minister of Energy has publicly supported EGEP, the Government has not chosen to rely solely on that process to deliver the outcomes it has sought. The Government enacted the Electricity Amendment Act 2001, which received Royal Assent on 7 August 2001 (Folder of Supporting Material, number 8) which confers a power on the Minister of Energy to regulate to achieve the Government's policy outcomes for the electricity industry in the event the industry is not successful in meeting the Government's objectives.
- 4.13 The main way in which the Electricity Amendment Act ensures that the Government's policy for the electricity industry is achieved is by granting the Minister of Energy the ability to establish a Crown entity to govern the industry if the Minister considers such an entity is necessary ("**Crown EGB**"). This will likely occur if the electricity governance organisation established by the industry, Electricity Governance Board Limited ("**Industry EGB**") (which is the Applicant) and the broader Arrangement, fail to operate effectively, or at all.
- 4.14 The Act provides significant regulation-making powers to provide for matters that the Government considers important, and to control the Industry EGB or the Crown EGB (once established). The Electricity Amendment Act inserts provisions into the Electricity Act 1992 providing for regulations to be made for the following matters in these situations:
- (a) At any time the Governor General may make regulations (section 16, inserting section 172B of the Electricity Act):
- (i) requiring electricity providers to make available to domestic consumers a tariff option that includes a fixed charge for delivered electricity; and
 - (ii) controlling the variable charges in the tariff option to ensure that average domestic consumers would pay no more than on an alternative plan;
- (b) If the Crown EGB is established, and either the Crown EGB makes a recommendation to the Minister, or the regulation is for transitional purposes if

the Crown EGB has not yet made a recommendation, the Minister may recommend regulations (section 172D of the Electricity Act):

- (i) providing for the establishment and operation of wholesale markets for electricity;
- (ii) requiring industry players to comply with these regulations;
- (iii) prescribing reasonable terms and conditions on which Transpower must enable distribution lines, generators and users of electricity to be connected to the national grid;
- (iv) regulating the way in which expansions, replacements, or upgrades of the national grid must be carried out and funded;
- (v) setting quality and security standards for the transmission system; and
- (vi) requiring the use by Transpower of a specified methodology for allocating Transpower's revenue requirement;

(c) Whether the Crown EGB is established or whether the Industry EGB is established, the Minister may recommend regulations (section 172F of the Electricity Act):

- (i) establishing a complaints resolution system for complaints from any person about distributors and retailers, including a code of practice, requirements for distributors and retailers to establish and maintain procedures for handling complaints, and provision for compensation up to maximum of \$20,000 to be awarded by the complaints resolution authority;
- (ii) requiring electricity retailers to offer prepayment meters to domestic consumers at a reasonable cost;
- (iii) providing a system or set of rules that will enable any consumer to choose between retailers;
- (iv) providing a system of transition arrangements for consumers in the event of a retailer becoming insolvent;

- (v) prescribing reasonable terms and conditions on which line owners and electricity distributors must enable generators to be connected to distribution lines other than the national grid;
- (vi) providing transparency on hydro spill, and so minimising hydro spill and promoting the efficient use of energy and other resources, including requiring hydro generators to disclose information in relation to the amount, location, timing of, and reasons for, any hydro spill;
- (vii) requiring retailers and generators to supply information relevant to hedge prices to a central collection agency, and requiring that agency to collate and disclose aggregated information on hedge prices, with the objective of providing information on the expected balance between electricity supply and demand to help investors and consumers make decisions on providing for security of supply; and
- (viii) providing procedures for resolving disputes between industry players.

4.15 The Act provides a credible regulation threat, and gives the industry an incentive to implement its own solution to meet the Government's expectations as outlined in the GPS. The industry is aware that if this application is not successful or the Arrangement once authorised is never activated in an operational sense, then the Government is likely to use the powers specified in the Electricity Amendment Act 2001. In response, the industry has developed the proposed Arrangement which is the subject of this Application.

APPLICATION

5. APPLICANT

5.1 The applicant is Electricity Governance Board Limited ("**Applicant**"), an intended party to the Rulebook. The Applicant is the governing body charged with administering the Rulebook. The Applicant will be bound by deed poll to perform its obligations contained in the Rulebook (attached as Appendix C). The Applicant will also be a party to many of the contracts which give effect to the Arrangement, including the service provider contracts.

6. SCOPE OF THE ARRANGEMENT FOR WHICH SPECIFIC AUTHORISATION IS SOUGHT

Development of the Arrangement

6.1 The Arrangement is centred around the Rulebook which is summarised below and attached as Appendix A. The rules established by the industry and embodied in the Rulebook have been developed by EGEN, and are the result of extensive consultation between all industry players, including generators, distributors, purchasers, the grid owner, and consumers, over the past year. The Rulebook has been developed through three working groups whose members represent interested parties:

- (a) the Governance Working Group, which has developed the governance provisions which now appear as Part A;
- (b) the Rationalisation Working Group, which is responsible for the rationalisation of the existing operational rules of MARIA and NZEM and the proposed MACQS rules; and
- (c) the Transport Working Group, which has developed the transport provisions governing transmission and distribution and which appears as Part F.

6.2 EGEN has put the Rulebook out to consultation twice, once in June and once in September. Through these consultations, affected parties have been able to make submissions on the Rulebook and such submissions have been taken into account in drafting the rules. The Rulebook represents a negotiated set of rules that meets the requirements of the industry as a whole. It reflects the interests of all participants although self-interest has been compromised on many issues.

The need for an authorisation

6.3 The Applicant accepts that the provisions which set a price for services supplied by members to non-members breach section 30 (see paragraph 24.22) and others may take the view that there are other contraventions of Part II of the Act. Accordingly, an authorisation is sought for the Arrangement (the elements of which are set out in paragraph 6.6) under section 58 of the Act to the extent the Arrangement contains the specific characteristics described in paragraph 6.7.

6.4 Under the Act, an authorisation can authorise a party to enter into, or give effect to a provision of, an "arrangement". Given the complexity of the overall Arrangement, the Applicant has attempted to assist the Commission by identifying those characteristics of the Arrangement which it believes could possibly be considered to breach Part II of the

Act. The Applicant does not consider it appropriate for the authorisation to cover a characteristic not specifically brought to the Commission's attention. Accordingly, the Applicant accepts that the authorisation should only apply to those provisions of the Arrangement which give rise to the identified characteristics.

6.5 It is intended that authorising the Arrangement in this manner will avoid the need to seek fresh authorisations for amendments which do not lessen competition in any market relative to the Arrangement as authorised, do not adversely impact upon the net public benefit associated with the Arrangement and do not otherwise contravene Part II of the Act.

Elements of the Arrangement

6.6 The Arrangement is comprised of the following contractual elements:

- (a) The Rulebook, which essentially establishes the market and provides rules by which the market will operate (Appendix A);
- (b) Service provider contracts (yet to be agreed), which will be entered into between the Industry EGB and the various service providers. The service providers, described more fully in paragraph 13.17, are necessary for the efficient functioning of the market;
- (c) A declaration of trust in which the trustee shareholder declares that it holds the single share issued by the Industry EGB on trust for the members of the Rulebook (Appendix B);
- (d) The deed poll to be executed by the Industry EGB, under which the Industry EGB will agree to be bound by the rules in the Rulebook. The Industry EGB will be a participant under the Rulebook, rather than a member (Appendix C);
- (e) The individual contracts (yet to be drafted) by which members will agree to be bound by the Rulebook;
- (f) Ancillary service contracts, to be entered into between Transpower and ancillary service providers, which are used to maintain frequency quality and overall security on the grid; and
- (g) System operator policy statements and procurement plans, which will be agreed between the system operator and the Industry EGB at least every 12 months. These statements will specify the policies which the system operator

will use in the real time co-ordination of the grid and its proposed arrangements for the procurement of ancillary services.

Characteristics of the Arrangement relevant to the Authorisation

6.7 The characteristics of the Arrangement for which authorisation is sought are limited to:

(a) Comprehensive coverage of the Rulebook

The Rulebook establishes a single multilateral trading market, which industry players are encouraged to join. It is envisaged that, at least initially, all industry players will belong to the Rulebook. Some of these provisions are aimed at enforcing the terms of the Rulebook, such as the provisions requiring members to contract with non-members on the same terms and conditions as they would contract with members (except if that non-member has resigned and has acceptable alternative arrangements in place). The Rulebook places limitations on exiting, as members who wish to exit must first satisfy the Industry EGB that they have acceptable alternative arrangements in place. This is considered by the Industry EGB with reference to matters such as reconciliation arrangements, security arrangements, access to transmission services, and prudential requirements. For a complete list see paragraph 14.4.

(b) Price determination process

The processes by which prices are determined for wholesale electricity are specified in the Rulebook. This includes the functions of the clearing manager who invoices the market purchasers and the generators (effectively issuing a purchaser invoice in the case of generators). The clearing manager ensures that the market clears by imposing the price calculated by the pricing manager on all parties to the arrangement. The pricing manager calculates the price in accordance with a specified formula in the Rulebook.

The price which members must charge non-members for Rulebook-type services is specified in the Rulebook.

The Rulebook also includes a process for determining the pricing methodology which applies in relation to transmission providers (including Transpower).

(c) Uniform standards

The Rulebook contains common quality arrangements and metering standards.

(d) Performance assurances

Various rules such as the prudential requirements and entry requirements that must be fulfilled before an applicant can become a member are designed to ensure compliance with the Rulebook but could potentially operate as barriers to entry.

(e) Transmission service definitions and transmission investment

Part F contains processes for determining the set of transmission service definitions and measures from which Transpower and Transpower customers select service definitions and measures that apply to the transmission services supplied by Transpower to that Transpower customer. This section also includes a discussion of the process for agreeing service changes and the process by which Transpower customers contribute to the costs of investment.

(f) Cost allocation

Allocation of costs, including common costs, such as service provider costs.

(g) Information disclosure requirements.

6.8 For the avoidance of doubt, the authorisation does not encompass:

- (a) Future performance and technical obligations from time to time decided under the overall arrangement;
- (b) Particular sanctions from time to time decided under the overall arrangement for the non-compliance with technical and other requirements; or
- (c) Particular methodologies developed and approved under the Rulebook for transmission pricing (section III of Part F).

7. FUTURE CONTRACTS AND AMENDMENTS

7.1 Contracts that are yet to be completed, such as the service provider contracts, which give effect to the Arrangement are not considered to require further authorisation to the extent that they simply give effect to the Arrangement as authorised providing that the contract does not lessen competition in any market relative to the Arrangement as authorised, does not adversely impact upon the net public benefit associated with the Arrangement, and does not otherwise contravene Part II of the Act. Similarly, it is intended that future amendments to the Rulebook will not require authorisation unless they contain anti-competitive elements not authorised in the present application.

- 7.2 The Rulebook provides that if any rule change requires regulatory approval, the Industry EGB will seek that regulatory approval before the rule change takes effect (rule 1.14, section IV, Part A).

8. AFFECTED PARTIES

- 8.1 The individuals and organisations directly affected by this practice, either as possible members of the Rulebook or otherwise affected, are set out in Appendix E. An electronic version of this table is available if required.

9. PARTIES TO WHOM THE AUTHORISATION WILL APPLY

- 9.1 In accordance with section 58B of the Act, any authorisation granted by the Commission pursuant to this application is intended to relate to all parties to the Arrangement from time to time, not simply the Applicant. The Applicant anticipates that these parties will comprise:

- (a) The Applicant, the Industry EGB;
- (b) Generators;
- (c) Distributors;
- (d) Retailers;
- (e) Direct consumers;
- (f) Grid owners;
- (g) The Rulings Panel; and
- (h) Service providers.

- 9.2 The Applicant intends that any authorisation granted will apply to members of the Rulebook as well as participants of the Rulebook who agree to be bound by the Rulebook. This includes any entity who may in the future become a party to the Arrangement. These entities will become parties to the Rulebook or one of the associated contracts and therefore any authorisation granted to the Applicant will apply to these parties also by virtue of section 58B(2) of the Act.

10. CONTRACTS TO BE ENTERED INTO

- 10.1 The Applicant notes that various industry parties intend to enter into a Transitional Dispensation Agreement after the application is submitted, but prior to the application being considered (attached as Appendix D). The purpose of this agreement is to give asset owners a degree of certainty about how existing plant will be treated under the Rulebook before they are required to vote for adoption of the Rulebook, and to give the system operator a level of certainty about the performance capabilities of existing plant before it assumes a real time co-ordination role. The technical standards in the Rulebook were designed to be appropriate for new plant. This means that special arrangements are needed to accommodate existing assets that are essential to the efficient operation of the grid and that were built and connected to the grid under previous arrangements. The Transitional Dispensation Agreement is not part of the Arrangement.
- 10.2 Dispensations must be granted upon the commencement of the rules. Therefore, it is necessary that Transpower begin gathering information so that it can make meaningful decisions regarding dispensations upon commencement of the Rulebook. In addition, existing asset owners require a level of certainty regarding their ability to belong to the Rulebook and connect to the grid. The Transitional Dispensation Agreement is intended to facilitate the process of moving to an operational Rulebook and will not affect competition in any market. The operative provisions relating to the granting of a transitional dispensation are included in the Rulebook and any transitional dispensation is therefore dependent on the outcome of this application. Therefore, the agreement does not give effect to the Rulebook, it is simply entered into to ensure that the Rulebook is able to become operational without excessive delays, once a final determination is made by the Commission.

PROPOSED ARRANGEMENT

11. OBJECTIVES AND INTENTION OF THE ARRANGEMENT

Reasons to the Arrangement

- 11.1 The intention of the Arrangement is to provide a system of governance and processes for trading to enable the electricity industry to operate effectively and efficiently. The Arrangement is intended to overcome inefficiencies in the current market structure, which arise because:

- (a) There are three governance arrangements, one for each of NZEM, MARIA and MACQS, which can be rationalised and combined into one governance organisation. There are considerable overlaps and similarities between the rules of NZEM and MARIA. However, each is administered under a separate rulebook and governance structure;
- (b) Members of MARIA currently receive benefits from the NZEM market for which they do not contribute, such as security and trading. The Arrangement ensures that all members (i.e. all generators, purchasers, distributors, grid owners and direct consumers who agree to be bound by the rules) contribute to the costs of operating the market. The Rulebook also provides disincentives for not belonging to the Rulebook, such as the rules concerning comprehensive coverage, which require members to contract with non-members on the same terms and conditions as they would contract with members, but at a higher price to reflect the uncertainties and extra costs involved with dealing with non-members; and
- (c) There is significant uncertainty around areas such as quality and transmission, areas which have historically not been subject to agreement between industry players. The Arrangement seeks to resolve that uncertainty by providing contractual clarity.

11.2 The Rulebook has been prepared for the purpose of governing the arrangements between members to promote the satisfaction of consumers' electricity requirements in a manner that is least cost to the economy as a whole and is consistent with sustainable development (foreword to Rulebook). The Industry EGB is charged with governing the Arrangement. It is intended that through the workings of the Industry EGB, the industry and wider stakeholders will be able to raise and solve issues and concerns. The foreword to the Rulebook states:

Interacting with industry and stakeholders the Board will promote an environment which fosters innovation and competition in the electricity industry for the long-term benefit of consumers.

- 11.3 The objectives of the Arrangement are to achieve the following as efficiently as possible:
- (a) To facilitate the trading of electricity between members of the Rulebook by establishing standards and processes which are efficient and effective;
 - (b) To create a joint "buying club" so that members can purchase services (services that are necessary for the entire industry) as a group; and

- (c) To provide a level of certainty about the technical standards which are required for common quality. This is necessary for long term investment decisions.

12. GUIDING PRINCIPLES

12.1 The Rulebook contains ten guiding principles. The guiding principles are intended to provide a guide for rule changes and to be a touchstone for the evolution of the rules, so that the rules achieve progressively greater consistency with the guiding principles. As industry players develop systems and ways of trading, and as technology develops to allow more efficient mechanisms the rules will need to evolve in a manner consistent with the guiding principles. A working group considering a proposed rule change must consider whether the rule change is consistent with the guiding principles when considered as a whole (rule 1.5, section IV, Part A). The guiding principles provide that the rules should collectively:

- (a) foster improvements in economic welfare by establishing market mechanisms and other processes for the supply and use of electricity and related services;
- (b) promote the efficient use of scarce resources in satisfying the electricity requirements of consumers;
- (c) where efficient, establish mechanisms and processes that foster competition in electricity and related services;
- (d) foster levels of performance that consumers want and are prepared to pay for;
- (e) favour voluntary membership of parts of the Rulebook except where an improvement to economic welfare can only be attained by mandating membership;
- (f) ensure that appropriate mechanisms and processes relating to common services are established and maintained to enable collective agreement on price, quantity, quality of supply and other terms and conditions for the purchase of common services and the trade-offs between them and ensure that participants in collective decisions are those parties who bear the costs and risks of such decisions;
- (g) ensure the rules are effective, transparent and commercially practical and that information is made available and actions taken in a timely and effective manner;

- (h) ensure the process by which the rules evolve is transparent and neutral;
- (i) be robust and enforceable by providing for, and maintaining, a compliance regime that is neutral, independent and with sufficient authority; and
- (j) comply with all relevant laws, including the Commerce Act 1986 and the Electricity Act 1992.

13. OVERVIEW OF ARRANGEMENT

13.1 The wholesale supply of electricity on the national grid has special characteristics which distinguish it from other commodities that are bought and sold. In particular, supply must always be actively matched in real time to the level of demand. Because all parties are interconnected through the grid, the actions of one participant have physical and commercial repercussions for others and for the real time security of the national grid. This interdependence means that the market necessarily requires physical co-ordination in real time. The foreword to the Rulebook states that the rules contained in the Rulebook:

- (a) establish and prescribe the mechanism by which the rules are specified, agreed, monitored and enforced, and disputes resolved;
- (b) prescribe rules for trading of wholesale electricity;
- (c) prescribe rules that underpin a regime designed to allow retail customers to choose their supplier of electricity;
- (d) prescribe rules for establishing and maintaining common quality (including security) standards over the integrated transmission system; and
- (e) prescribe the rules relating to the development and evolution of transmission services, and a transmission pricing methodology.

13.2 In addition, the Rulebook prescribes rules for the measurement of electricity supplied to the grid and taken from the grid. It is important for accuracy of measurement that meters are installed and operate according to specified standards. The Rulebook also provides for transitional provisions, managing the switch from NZEM, MARIA and MACQS to the Rulebook.

13.3 For the competitive electricity market in New Zealand to operate securely and efficiently, supply and demand must be actively co-ordinated in real time. To achieve this it is necessary to dispatch generators and ancillary services so that uncertain and

continuously varying consumer demand is met whilst maintaining common quality and security standards. On the interconnected national grid one generator's electricity cannot be distinguished from another's and it is not feasible for a particular generator to independently supply a particular customer a separately identified block of electricity. Instead, electricity is fed into the grid through a pooling arrangement which enables generation and demand to be matched continuously. The Rulebook provides for this to occur efficiently. It is then necessary to determine quantities injected and taken off at particular locations for the purposes of determining the amounts payable by or to participants.

Industry rationalisation

13.4 The Rulebook provides the rules for the operation of the electricity market, and essentially combines and rationalises:

- (a) NZEM, which provides for multilateral trading of energy over the grid;
- (b) MARIA, which establishes arrangements for the measurement and reconciliation of electricity flows, for bilateral transactions between wholesale participants over the grid, and for the switching of retail customers between retailers;
- (c) MACQS, which sets out the process for reaching agreement as to the desired level of common quality; and
- (d) Two new sections, which are not currently part of any of the operative codes governing the industry. These two parts deal with consumer issues (Part B) and transport (Part F). The rules relating to consumer issues have yet to be developed, but may (over time) include rules relating to the consumer complaints regime and other related issues dealt with in the GPS. The rules relating to transport concern transmission services, and attempt to provide guidance in the relationship between Transpower and its customers, which historically has been characterised by contractual uncertainty and dispute. Part F also contains the process for determining the pricing methodology to be adopted by transmission providers, including Transpower.

13.5 The Rulebook amalgamates NZEM, MARIA and the rules developed under MACQS, but provides for bilateral trading arrangements only through recognition of financial arrangements. Currently, MARIA enables parties to settle contracts directly with each other and any differences after adjustments for transmission losses and constraints are settled with NZEM using the NZEM clearing price adjusted by a 10 percent discount and

premium according to whether NZEM purchases energy from or sells energy to the bilateral party. These arrangements have been replaced in the Rulebook by a requirement that dispatch of all quantities transacted across the grid is achieved through the prescribed multilateral offer and dispatch process. However, parties may notify the clearing manager of bilateral financial arrangements which the clearing manager takes into account in determining amounts due from purchasers and owing to generators. Alternatively, these bilateral financial arrangements could occur entirely outside the Rulebook.

Previous applications to the Commission

13.6 The Applicant notes that:

- (a) Three aspects of NZEM were the subject of an authorisation application: the pricing mechanisms, the prudential requirements and the adoption of metering standards. The Commission declined jurisdiction to consider the authorisation in Decision 280 on 13 September 1996 on the basis that the provisions did not lessen competition; and
- (b) MACQS was the subject of an authorisation by the Commerce Commission in Decision 369 on 13 August 1999. The authorisation was granted and standards relating to common quality have now been reached under MACQS and are incorporated in the Arrangement.

Contents of the Rulebook

13.7 The following table sets out a brief explanation of the individual parts of the Rulebook (a more extensive description can be found in section 14):

Part	Description
A	Governance: Establishes the governance arrangements for the industry, and includes membership provisions and information disclosure rules.
B	Consumer issues (to be drafted).
C	Common quality: contains system operator principal performance objectives, asset owner performance obligations and purchaser obligations. Also provides for ancillary services. Includes technical codes.

D	Metering arrangements: contains rules relating to metering arrangements and metering standards.
E	Registry information and customer switching: contains rules establishing the registry and switching processes for consumers to switch retailers.
F	Transport: contains rules surrounding transmission services.
G	Trading arrangements: contains rules governing bids and offers, preparation of a pre-dispatch schedule, dispatch, reconciliation and price calculation.
H	Clearing and settlement: contains rules specifying prudential requirements; also provides rules for the clearing manager, who issues invoices to generators and purchasers and collects money from purchasers to pay to generators. Also provides for payment of other fees to clearing manager, such as fixed membership fees.
I	Implementation and transition: provides for the transition from NZEM, MARIA and MACQS to the Rulebook.
Annexure A	Defined terms.

- 13.8 It is intended that all players in the electricity market (that is generators, retailers, distributors, grid owners, direct consumers and service providers) will enter into contracts agreeing to be bound by the Rulebook. The Rulebook differentiates between members and participants. Members are industry players (such as generators, purchasers, distributors, grid owners and direct consumers). Members have voting rights and obligations in relation to fees. Consumers not subject to the Rulebook are also allocated votes for Part C (common quality), but must first submit a written application to the Industry EGB to become a member. Consumer groups and approved consumer representatives may vote in an election of directors of the Industry EGB, but before voting such consumer representatives must be approved by the Rulings Panel. Votes are allocated on the basis of electricity consumed by the consumer group or representative or by the interest groups they are appointed to represent.
- 13.9 Members are a subset of participants. In addition to members, participants include others parties which have rights and obligations under the Rulebook, such as the Industry EGB, the Rulings Panel (which determines disputes), and service providers

(such as the system operator, the reconciliation manager, the clearing manager, the pricing manager, the registry and the market administrator).

Physical trading market and metering

- 13.10 The Rulebook establishes an electricity market in which generators make offers, and retailers and direct consumers may make bids. Dispatch is controlled by the system operator (Part G). The system operator dispatches the generators with the lowest bids first, until all demand is satisfied (except in special system security situations where the dispatcher may alter the dispatch order to ensure the security of the grid). The reconciliation manager determines the amount of electricity supplied by each generator or taken by each retailer or direct consumer. The information relating to quantities is obtained from meters, which are installed at specified points on the grid. Metering standards are necessary for the trading arrangements to operate (Part D). It is the responsibility of the reconciliation manager to determine the quantities of electricity supplied and taken, and for this the reconciliation manager must have access to accurate metering information. The pricing manager then calculates the price paid or received by each participant in the market according to a prescribed formula, and the clearing manager receives payment from purchasers and pays generators (Part H). The market arrangement under the Rulebook is a multilateral arrangement. However, industry players are free to enter into financial arrangements under which they may effectively contract bilaterally to manage risk exposure to the spot market (see paragraph 13.5).

Common quality

- 13.11 Electricity standards provide for a level of quality of electricity. Maintaining security of supply is a critical aspect of electricity quality. However, quality of supply extends well beyond simply keeping the lights on. Almost as important is maintaining the quality of voltage and frequency on the grid. If supply voltage or frequency is not maintained to an appropriate quality standard, electrical equipment may fail. The potential consequences of poor quality of supply to motors includes wasting energy, overheating, failing or shutting down automatically with increased costs, disruption, and even safety risks, depending on the processes involved (GSC Handover Package, Industry Primer, 28 September 1999, Folder of Supporting Material, number 5).

Transmission

- 13.12 Generators supply electricity to purchasers either directly or, more normally, across the interconnected set of wires which form the grid owned by Transpower. Accordingly, generators have agreements with Transpower to transport their electricity across the

national grid. Contracts between Transpower and its customers have historically been hampered by high levels of uncertainty over the characteristics of the transmission services, a lack of price signalling, free riding and incomplete information. While these agreements will still be subject to normal contract law, they are affected by Part F which provides processes under which Transpower and its customers will initially define the services and the levels of service being delivered, which may be incorporated into their contracts. Transmission providers (including Transpower) and transmission purchasers may subsequently change the service definitions or levels. In addition, Part F provides a consultative process by which Transpower and other transmission providers determine pricing methodologies for pricing their services. Once these methodologies have been developed, and an auditor has confirmed that they are applied correctly by the transmission provider, the transmission purchaser may not challenge such prices on the basis of the invalidity of the pricing methodology.

- 13.13 Transpower is still subject to the process contained in Part 4A of the Commerce Act, which provides for control of Transpower's prices, or authorisation of all or any component of Transpower's pricing methodology. Under section 57F of the Commerce Act, the Commission may declare all or any goods or services supplied by a "large electricity lines business" in markets directly related to electricity distribution and transmission services to be controlled. This applies to Transpower since Transpower owns the national grid. The Commerce Commission sets thresholds for the declaration of control in relation to large electricity lines businesses, and may only declare goods or services of Transpower (for example, as a large electricity lines business) to be controlled if the thresholds are exceeded. Before declaring Transpower's prices to be controlled the Commission must follow a prescribed process which includes having regard to the views of interested persons.

Customer switching

- 13.14 The main catalyst for the competition for consumers between retailers was the removal of the franchise boundaries, described in paragraph 2.7. Consumers can, and do, switch electricity retailers. Part E, which reflects rules currently contained in MARIA, provides procedures for switching by consumers. A registry is established to store information relating to ICPs, such as the status, current retailer, profile and meter owner (amongst other things). Part E also contains provisions establishing a process to govern the switching of consumers between retailers. Importantly, Part E provides that a retailer may not cease to provide electricity to a consumer unless another retailer has agreed to enter into a contract for the sale of electricity, and this has been notified to the registry, or that consumer ceases to take electricity at that installation control point.

Governance

- 13.15 Operating a market such as the electricity market requires significant co-ordination and governance. The rules in Part A establish the governance structures of the industry. Part A provides for the commencement of the rules, the development of new and replacement rules (which must be by reference to the guiding principles, as described in paragraph 12.1), the establishment of the Industry EGB (which will facilitate the market's operations), the establishment of a Rulings Panel to determine disputes, the rules relating to voting, the rules relating to admission as a member and resignation of members from the Rulebook, and information disclosure provisions. As described, Part A includes a list of guiding principles which are intended to guide the industry in the development of the Rulebook, as the Rulebook evolves over time.
- 13.16 Establishing and maintaining an operative system necessarily involves costs, which are allocated amongst members. Other costs are also allocated amongst members, such as the costs of common quality, which are allocated to users of these services (for a more detailed description of cost allocation, see section 28). Members of particular parts are allocated the costs of those particular parts, while general costs, such as governance costs, are allocated amongst all members (Part H and Part A).

Service providers

- 13.17 The rules relating to service providers, the entities necessary to ensure the market operates effectively, are also contained in Part A, including, the rules by which the Industry EGB enters into a contract with a service provider and for the review of service providers. The service providers are:
- (a) The system operator, which will receive bids and offers, collect information, forecast prices, prepare pre-dispatch schedules, and issue dispatch instructions;
 - (b) The pricing manager, which collects data and produces provisional prices and final prices;
 - (c) The reconciliation manager, which carries out the reconciliation process and determines the actual amount supplied or purchased by each participant;
 - (d) The registry, which gathers and stores information relating to ICPs, and provides information relating to switching;
 - (e) The clearing manager, which receives payment for electricity from purchasers (retailers and direct consumers) and pays generators based on the information

provided by the reconciliation manager and the pricing manager. Hedge agreements may also be notified to the clearing manager and settlement conducted through the clearing manager; and

- (f) The market administrator, which collects information relating to market players and market events, including breaches of the rules, provides information where necessary to interested parties, and undertakes other administrative functions set out in the rules.

- 13.18 It is intended that the first service providers will be those who currently hold equivalent positions within NZEM. For example, the first system operator will be Transpower. This is to ensure system security and efficiency, because the incumbents have the necessary knowledge and expertise to manage the transition to the new Arrangement, and perform the service provider roles in the initial period of operation of the Rulebook. However, these initial service provider contracts will be for a limited period, which will likely vary from service provider to service provider, after which it is intended that the service provider roles will become contestable.

Transitional provisions

- 13.19 Since the Rulebook is intended to replace NZEM, MARIA and MACQS, transitional provisions are needed to wind down the obligations in NZEM and MARIA. Co-ordinating the termination of the current codes with commencement of the Rulebook is vital. Part I provides for these transitional provisions.

14. ANALYSIS OF INDIVIDUAL PARTS OF THE RULEBOOK

- 14.1 The operative provisions of the Rulebook are described below.

Part A - Governance

- 14.2 Part A of the proposed Rulebook deals with the overall governance of the proposed Arrangement. Consistent with the existing self-regulatory arrangements (NZEM, MARIA and MACQS), the proposed rules commence with a set of guiding principles. In essence the guiding principles provide the constitutional underpinning for the market and governance design. The work of the Industry EGB will be governed by the guiding principles and they are the touchstone against which rule change proposals are assessed. The proposed set of guiding principles has been developed independently of other existing codes in light of the evolving design of the Rulebook.

- 14.3 Part A also establishes the Industry EGB, the primary governance body under the Rulebook. Its prime duty is to oversee the operation and evolution of the rules. The board of directors of the EGB is comprised of seven individuals, each of whom must be independent. Following a prescribed public nomination process, directors of the Industry EGB are elected by generators, purchasers, distributors, grid owners and approved consumer representatives.
- 14.4 The Industry EGB has responsibility for approving applications to become members of the rules, which are to be granted provided specified criteria are satisfied. Members are entitled to resign but their resignation will only be effective on a date determined by the Industry EGB. In determining this date, the Industry EGB takes into consideration the following matters:
- (a) Whether the member is under investigation;
 - (b) Whether the Rulings Panel has determined that it is desirable to suspend trading rights;
 - (c) Whether the member has any outstanding financial obligations; and
 - (d) Whether a member who intends to continue to participate in the electricity industry has acceptable alternative arrangements in place. The Industry EGB determines whether the member has acceptable alternative arrangements in place, having regard to enforcement mechanisms, and:
 - (i) When the resigning member is a generator, whether that member has appropriate processes in place for dispatch of generation, reconciliation, and transmission services, and whether the generator has provided for continued compliance with applicable asset owner performance obligations and metering standards;
 - (ii) When the resigning member is a purchaser, whether that purchaser has established appropriate processes for reconciliation, transmission services and notifying demand to the system operator, whether the purchaser has provided for an appropriate level of prudential security to protect members of the Rulebook, and whether the purchaser has provided for continued compliance with applicable asset owner performance obligations and metering standards; and
 - (iii) When the resigning member is a distributor, whether that distributor has provided for continued compliance with applicable asset owner

performance obligations, whether the distributor has ensured transmission services are available, and whether the distributor has established appropriate mechanisms for the provision of information to facilitate switching of customers between retailers.

- 14.5 The intention of the resignation provisions is to ensure that:
- (a) a resigning member has complied with all its obligations under the Rulebook while it was a member, particularly in regard to disciplinary action; and
 - (b) members who leave the Rulebook but continue to operate in the electricity industry do not threaten the security of the market or undermine the efficiency of the Rulebook.
- 14.6 For two years after the effective date of resignation the member remains subject to the Rulings Panel in respect of actions prior to the effective date or proceedings commenced prior to the effective date. This is to ensure that the member remains subject to the jurisdiction of the Rulings Panel in relation to breaches of rules prior to the effective date of the resignation.
- 14.7 Part A also includes the process by which rules are made. The rule-making process is similar to those existing under current self-governance arrangements and involves receiving rule change proposals, consideration of proposals by industry working groups, procedural steps around accepted and non-accepted rule changes, and voting requirements by members. The process is under the overall control of the Industry EGB.
- 14.8 As with NZEM and MARIA, Part A specifies a compliance regime to ensure that members comply with the rules on an ongoing basis. The Industry EGB also oversees the compliance regime. The Rulebook establishes a body known as the Rulings Panel. All members must submit to the jurisdiction of the Rulings Panel, which adjudicates on compliance matters. With the exception of overall control of the compliance regime (which rests with the Industry EGB), the Rulings Panel has similar functions to those presently carried out by the Market Surveillance Committee of NZEM and the MARIA Conduct Committee. The Rulings Panel has the ability to levy a full range of sanctions, including fines and compensation orders.
- 14.9 Part A also imposes a general duty on participants (including members) to make all information supplied to them by any participant available to other participants on request, except where compliance with the law requires otherwise. Generators, purchasers and service providers are also obliged to publicly disclose all information

concerning their electricity businesses where that information is likely to materially affect the electricity price, except where the party concerned would be commercially disadvantaged by such disclosure or such disclosure is prohibited by law. This has been added at the insistence of small industry players and consumer interests to aid the transparency of decision-making. Special requirements apply to trading information which (unless the Industry EGB directs otherwise in relation to historic bid and offer information) is required to remain confidential because it affects or could affect price, including bids and offers.

- 14.10 Part A includes new rules not existing in present self-governance arrangements, which relate to the provision of services to non-members. The purpose of these rules is to specify a process and set of obligations on members and service providers to govern relationships with non-members in circumstances where those non-members receive benefits or services from the arrangement but would not otherwise contribute to the cost of providing those benefits and services. The intention is to encourage non-members to join the Rulebook, to protect the efficiency and integrity of the system.
- 14.11 The rules provide for a fair price for services or benefits to be levied against non-members. The fair price is derived by reference to the arrangements regarding fees and charges to members and any extra costs arising from the fact of non-membership.
- 14.12 Members are entitled to refuse to deal with non-members. Where a participant supplies services or benefits to a non-member in circumstances where no contract exists then the Industry EGB is empowered to seek quantum meruit recovery of the fair price of those services or benefits by way of litigation.
- 14.13 Part A also sets out the voting rights for each part, in Schedule A6. Members of each Part are generally allocated votes based on electricity generated and consumed. As previously discussed (paragraph 13.8), consumers are allocated votes in two parts, Part A and Part C. In Part A, approved consumer groups and consumer representatives (approved by the Rulings Panel) are allocated votes based on the total electricity consumed by the consumers or the groups they represent. In Part C, votes are allocated to consumers on the basis of electricity consumed, although consumers must first apply to the Industry EGB to become a member.

Part B - Consumer issues

- 14.14 This section of the Rulebook is yet to be drafted. The intention is for it to address consumer matters, which may include the Electricity Complaints Commissioner scheme.

Part C - Common quality

- 14.15 Part C reflects the rules developed under the process contained in MACQS for ensuring the quality of electricity and therefore security of the system. Achieving a given level of quality requires technical standards to be set for various elements of the electricity system, and the purchase of ancillary services such as instantaneous reserve, frequency control reserves, over-frequency arming, voltage support, load shedding and black start. These services are supplied for the purpose of maintaining the frequency and voltage on the transmission grid within specified ranges, or, in the case of black start, for the purpose of restarting the grid after an outage. The common quality rules, which reflect those developed under MACQS, are contained in Part C. These rules have been developed between Transpower and electricity users.
- 14.16 The system operator co-ordinates the transmission of electricity over the grid. This involves balancing electricity generation and consumption and the real-time dispatch of generators according to the price-based schedule (established under Part G). The system operator also co-ordinates the provision of equipment for the control of frequency and voltage and the procurement of suitable reserve capacity under all grid operating conditions. Section II of Part C sets out the system operator's obligations in relation to the delivery of common quality in real time. These obligations are deliberately framed as "objectives", rather than prescriptive requirements, in order to provide the system operator with flexibility about the operation of the grid in real time. The system operator's core obligation is to use reasonable endeavours to achieve the designated common quality outcomes, which include:
- (a) dispatch of available assets (i.e. generation plants) to avoid cascade failure of assets (resulting from frequency and voltage excursions or supply and demand imbalances);
 - (b) maintenance of frequency within the defined normal band and the management of frequency during momentary fluctuations;
 - (c) taking reasonable actions to maintain harmonics, voltage flicker and voltage imbalance within the stated standards; and
 - (d) restoration of normal operations of the power system following an emergency event in accordance with the agreed priorities.
- 14.17 Section II contains an obligation on the system operator to agree in advance with the Industry EGB the policies which it intends to apply in real time. This process also includes input from interested parties. The policy statement specifies the system

operator's requirements and proposed actions to maintain security under normal contingent and emergency conditions.

14.18 In addition to the obligations imposed on the system operator, section III of Part C sets out the technical standards and other obligations required to be met by asset owners to assist the system operator to achieve its security objectives. These standards apply to:

- (a) Purchasers, who are required to contribute to overall frequency management by limiting the magnitude of changes in offtake in accordance with the system operator's reasonable requirements;
- (b) Generators above the de minimis threshold (30 MW), who are required to:
 - (i) whilst synchronised, make the maximum injection contribution necessary to maintain frequency;
 - (ii) stay connected for the prescribed time when frequency drops to preset levels;
 - (iii) ensure their assets can operate within the designated voltage ranges; and
 - (iv) ensure their assets import and export the stated quantities of reactive power;
- (c) Transpower, as owner of the HVDC, which has obligations to support frequency, and as grid owner is required to:
 - (i) ensure its assets are capable of operating over the designated voltage ranges;
 - (ii) establish load-shedding arrangements; and
 - (iii) ensure the configuration of its assets and associated protection arrangements are consistent with the system operator's ability to meet its performance objectives.
- (d) Distributors, which are required to:
 - (i) establish automatic under frequency load shedding arrangements;
 - (ii) ensure their assets are capable of being operated over the designated voltage ranges;

- (iii) establish load shedding arrangements to prevent the collapse of network voltage;
- (iv) inform the system operator of persons connected to their networks who generate in excess of 1MW per annum; and
- (v) comply with any directive of the Industry EGB to extend the common quality obligations to generators below the de minimis threshold (30MW) embedded within their networks who are not otherwise members of the Rulebook.

14.19 Section III contains two important rights for asset owners:

- (a) The first is the right to substitute compliance with a particular standard with a technical or commercial arrangement which has a similar effect to an imposed standard, known as an "equivalence arrangement"; and
- (b) The second is a right to be exempt from any standard where it is prepared to pay the costs consequential on this exemption, known as a "dispensation".

14.20 Asset owners connected to the grid on 1 October 2000 have a further right: to have transitional dispensations granted pursuant to the Rulebook. In order to prepare for the granting of such transitional dispensations, Transpower and the grid security committee have entered into an agreement, the Transitional Dispensation Agreement (Appendix D). Under this agreement Transpower may begin collecting information and providing asset owners with an indication in advance of the Rulebook becoming operational of the likely terms of dispensations they would receive when the Rulebook becomes operational. This is intended to facilitate the Rulebook coming into effect and minimise delays.

14.21 The fourth section of Part C is concerned with the arrangements agreed by the industry for the procurement of ancillary services. Ancillary services include:

- (a) Frequency keeping reserves, which keep frequency relatively constant by smoothing out the lumps in demand. Free governor action aids in keeping frequency relatively constant by increasing output when frequency drops and vice versa, but this is not sufficient and not all generators have this capability. For this reason frequency keeping reserves are required. The system operator purchases this service through the procurement plan, and asks the provider of this ancillary service to keep frequency steady;

- (b) Instantaneous reserves, which also respond to a fall in frequency. These reserves are not as quick as free governors, but still respond relatively quickly (6 seconds). If a large plant fails, frequency will fall and generators will start tripping off the system, until there is eventual black out. Instantaneous reserves respond to the fall in frequency by increasing output or reducing load and therefore restoring frequency within approximately 30 seconds to 1 minute, thereby avoiding black out. Generators can offer either reserves or energy, so there is a trade off to be determined by generators when making offers;
- (c) Over-frequency arming, which is generally required in the South Island and is effectively the opposite of instantaneous reserves. If the HVDC link fails, then the South Island is producing too much energy and the frequency rises. The system operator purchases over-frequency arming services from particular generators, who agree to trip off first to stop all generators in the South Island tripping off and bringing the South Island into black out. The costs of this service are recovered from the HVDC owner, as it is a risk of the HVDC that is being catered for;
- (d) Black start, which provides a mechanism to re-energise the grid in the event of a black out. In such an occurrence, one generator will have to restart the system. This is provided by some power stations which have small portable generators to start the system if there is a nationwide black out; and
- (e) Voltage support, which ensures that the voltage remains steady throughout the system. This is needed because there is "leakage" over the system so that voltage drops over the length of the system.

14.22 Central to these arrangements is the agreement between the Industry EGB and the system operator of an annual procurement plan for the purchase of ancillary services. Section IV also contains a set of provisions which enable persons to avoid the costs of certain ancillary services procured by the system operator by establishing their own purchase arrangements. These are known as "alternative ancillary service arrangements".

Part D - Metering arrangements

14.23 Part D sets out the obligations in relation to metering arrangements, both at points of connection on the grid and at points of connection on local networks. In relation to points of connection on the grid, the generator, grid owner or distributor predominantly transferring electricity to another participant is responsible for the metering

arrangements. In relation to connection points on local networks, responsibility is either with direct consumers, embedded generators or retailers.

- 14.24 In the case of metering installations, whether in relation to points of connection on the grid or at points of connection on local networks, the rules specify:
- (a) a process for collecting and transferring data;
 - (b) a process for quantity data to be published (for the purposes of verification);
 - (c) detailed technical requirements for meters;
 - (d) the obligations for testing meters; and
 - (e) the processes to be followed in the event inaccuracies are found.
- 14.25 The objective of these rules is to ensure that the volume of electricity supplied or taken is measured at the same relative point for each participant to an acceptable level of accuracy.

Part E - Registry information and customer switching

- 14.26 Part E contains the rules relating to the collection of information relating to ICPs by the registry, and sets out rules for customer switching. These rules essentially repeat present MARIA rules. Retailers and distributors are members of Part E, unless they are part of an approved alternative switching arrangement approved by the Industry EGB.
- 14.27 The MARIA registry was established in April 1999 with the advent of retail competition. It was designed to be a central database of unique installation control point ("**ICP**") identifiers that would identify which retailer supplies each customer through the ICP for the purpose of permitting reconciliation of energy flows by the national reconciliation manager in the situation of a switch by a customer. The registry holds information required for this reconciliation, and is a central point for players to update the ICP information after a customer switch has occurred.
- 14.28 Part E specifies a process for customer switching. When a new retailer contracts with a customer they are required to advise the old retailer within two days and supply them with information relating to the ICP if there is one. The old retailer confirms the advice and information received within two days. The retailers then agree on a date on which either retailer will carry out an actual or estimated meter reading ("**event date**"). Within two working days of the event date, the retailers exchange metering information. Within three working days of the event date, the new retailer is required to update the registry

with the changes in retailer information relevant to that ICP. The registry then notifies the old retailer and the distributor of the change in retailer for that ICP and the event date. If any of the information held by the registry changes, the relevant retailer or distributor is required to update the registry. This process ensures smooth, effective customer switching, thereby facilitating competition between retailers.

Part F - Transport

- 14.29 Part F contains rules relating to transport. These rules provide for a process by which Transpower and its customers may agree service definitions and levels that apply to the transmission services supplied by Transpower to that customer, as well as a pricing methodology for that transmission service. The rules contained in Part F are new and are in response to the wishes of both the Government (through the GPS) and the industry, which wanted to better clarify the services provided by Transpower and the prices for those services.
- 14.30 Historically transport arrangements have been hampered by a lack of clarity surrounding definition of the service being supplied and the level of that service. The first section of Part F provides a process for clearly defining services and the service levels for those transmission services currently supplied by Transpower to its customers. The first step involves agreeing on a set of service definitions and measures applying to all services made available or supply by Transpower to all customers. Transpower and individual customers (or groups of customers) then meet to determine the service definitions and measures applying to the particular transmission services supplied by Transpower to that customer or customers. The next step involves determining levels of service supplied by Transpower. Although all customers go through this process, the resulting service definitions, measures and levels only apply in two instances:
- (a) Where there is a written contract between Transpower and the Transpower customer for that service, and both parties agree the service definitions, measures and levels should apply to those services; and
 - (b) Where there is a contract resulting from the posting by Transpower of the terms and conditions under which it will supply those services.
- 14.31 The intention of better defining the services supplied by Transpower is twofold:
- (a) To provide the basis for decisions relating to transmission investment and replacement;

- (b) To ensure better quality of service through better clarity of definition of the service; and
- (c) To ensure that Transpower is committed to supplying that particular level of service (where the level is incorporated into a contract). This occurs through a service delivery plan prepared by Transpower, which sets out Transpower's plan for achieving the service levels for the next ten years. The plan specifies how Transpower intends to achieve all service levels, through for example, investment, even if not incorporated into a contract. Transpower is, however, obliged to meet service levels only where they are contracted service levels.

14.32 Under normal conditions, the scarce resource in the wholesale electricity market is transmission capacity, not generation capacity. Available generation capacity typically exceeds demand by a comfortable margin. However, at certain points in time, constraints in the transmission network may limit the transfer capability of the grid preventing the utilisation of the lowest cost generators to meet demand.

14.33 Ensuring adequate future investment in capacity can help to alleviate the severity of dry winters. However, historically transmission investment faces complex technical and commercial issues. Investing in expensive and long term assets can be commercially risky and often unjustified, particularly if such assets are only utilised in extreme situations such as dry winters. Transpower's investment policy is to undertake investment where there is a threat to the security of the power system.

14.34 Section I of Part F provides for Transpower to develop a service delivery plan which may include a statement of investment opportunities. This service delivery plan sets out Transpower's plan for complying with service levels for a specified period. The statement of investment opportunities sets out proposed investment in new assets by Transpower. Transpower's customers may comment on this, and may propose alternative solutions to transmission investment. Once Transpower commits irrevocably to expenditure identified in the final service delivery plan, for the purposes of determining transmission prices, the value of the asset which is the subject of such new investment will not be reduced if demand for the service provided by the asset reduces within five years. The purpose of this protection is to provide Transpower with some certainty in relation to investment, and to create incentives for Transpower customers to reveal when they are considering alternatives, to reduce the prospect of wasteful investment. Transpower will, however, still be subject to the risk that through technological obsolescence the value of the asset will fall.

- 14.35 Part F also provides for future amendments to service definitions, measures and levels between transmission providers (such as Transpower) and transmission purchasers. By providing a process for changing service definitions, measures and levels, the intention is to give transmission purchasers who will be affected by the decision more input into this decision making. This process is also intended to eliminate the incentives to free-ride on investment decisions by other transmission purchasers, as a resolution on a service change which is passed is binding on all transmission purchasers eligible to vote (which are the transmission purchasers that the transmission provider considers will take the new or changed service), including those who voted against such service change proposal. All transmission purchasers eligible to vote are obliged to take the new or changed service.
- 14.36 Part F also specifies a process for determining the pricing methodology to be applied by Transpower and other transmission providers. In the case of Transpower, a pricing methodology is developed which applies to services currently delivered by Transpower and which are the subject of section I (defining service definitions, measures and levels). Other transmission purchasers must develop a pricing methodology when they change a service level (which, by definition, includes supplying a new service). Section III of Part F does not specify a particular price or pricing methodology but rather a process for developing a pricing methodology to apply to a particular service. Both the Industry EGB and transmission purchasers (including Transpower customers) have input into all aspects of this process. The Industry EGB must confirm that the pricing methodology developed by the transmission provider complies with pricing principles and objectives which have been taken from the GPS.
- 14.37 Once the pricing methodology is developed, the transmission provider develops specific algorithms for applying that methodology, and an auditor is appointed to verify the application of the methodology. Transmission purchasers, including Transpower customers, cannot challenge the validity of a confirmed pricing methodology or its application once verified by the auditor. Transmission purchasers may still, however, challenge the resulting prices on other grounds, for example on the basis of an error in calculation.

Part G - Trading arrangements

- 14.38 Part G contains the rules relating to the multilateral trading arrangement between members of the Rulebook. The financial aspects of bilateral trades may be replicated by way of separate financial arrangements. The rules in Part G derive from the rules of NZEM and were reviewed for suitability for inclusion in the combined Rulebook. The terms of reference of the working group charged with rationalising the three present

arrangements required it only to make those changes necessary to combine the existing codes.

14.39 The rules in Part G establish a wholesale market for electricity trading which has the following characteristics:

- (a) bids and offers for electricity and reserves are submitted;
- (b) the system operator prepares and implements dispatch arrangements based on trading prices;
- (c) the pricing manager calculates final prices; and
- (d) the reconciliation manager reconciles quantities traded and amounts owed.

14.40 An equivalent regime to the pricing mechanisms considered by the Commission in Decision 280 (the NZEM authorisation application, where the Commission declined jurisdiction) is included in the current Part G. However, there are a number of differences in the proposed wholesale market arrangements from those previously considered by the Commission, principally:

- (a) the composition of the governing entity;
- (b) the processes to effect a rule change (although votes are still held by generators and purchasers);
- (c) the "day ahead" market is no longer part of the arrangement; and
- (d) the new rules provide for all physical trades to be conducted through the multilateral wholesale market. Under current arrangements it is possible to have bilateral trades outside this market, through the MARIA rules.

14.41 The Rulebook provides for each generator to submit to the system operator the offers under which it is prepared to sell electricity to the clearing manager for each half hour of the following day at each location on the grid. Purchasers are also required to submit bids for the purchase of electricity from the clearing manager for the same time periods and locations. Offers and bids must also include information such as the generator's reasonable estimate of quantity capable of being sold, and the purchaser's reasonable estimate of quantities likely to be demanded. The role of the clearing manager is to act as a buyer to all sellers and a seller to all buyers.

14.42 Prior to the actual trading period, the system operator prepares pre-dispatch schedules which traders can respond to by adjusting their offers and bids. Revisions or

cancellation of offers and bids are permitted up to two hours before the relevant trading period. Changes within two hours of a trading period can only be made in the case of a grid emergency or for a bona fide physical reason.

- 14.43 In addition to the energy bid and offer process, the rules also contain mechanisms for the offer of instantaneous reserves which are similar to the energy offer process. Instantaneous reserves are electricity offered by generators which will be called upon if the frequency fluctuates, in order to restore the frequency to 50 hertz.
- 14.44 In real time the system operator formulates and issues dispatch instructions for generation and reserve offers in accordance with the dispatch schedule which relates to that trading period. The dispatch schedule is created using the methodology in the rules. This methodology ranks generators at particular locations according to price to establish the lowest cost production for given bids. Inputs to this process include offers, bids, information regarding the transmission system and reserve requirements for the different locations on the grid.
- 14.45 Section IV of Part G outlines the process for the pricing manager to produce provisional prices and final prices. Provisional prices are estimates of the previous day's trading, while final prices are the actual amounts to be paid.
- 14.46 The rules also reflect the fact that generators may be dispatched by the system operator and will supply electricity in periods where the price is below the price offered by the generator (constrained on). Similarly, the rules also recognise that generators may not be dispatched and may not supply electricity in situations where the price is above the price bid by the generator (constrained off). These market failures are due to transmission constraints, and are reflected in pricing adjustments.
- 14.47 Section V of Part G contains detailed processes by which members provide quantities and other information to permit the reconciliation manager to carry out the reconciliation process.
- 14.48 In summary the wholesale market has the following characteristics:
- (a) Scheduling and dispatch are generally based on price/quantity bids and offers;
 - (b) Generation is scheduled for each trading period to meet the expected demand at lowest cost (including losses);
 - (c) Effects of reserves, losses and constraints are priced into the market;
 - (d) Marginal location factors are determined for each half hour; and

- (e) Prices are established at each node of the transmission system.

Part H - Clearing and settlement

- 14.49 The rules in Part H concern the processes for the settlement of the sale and purchase of electricity under the Rulebook, together with various other payments, including amounts owing to service providers and to those members who pay for ancillary services. Part H also provides for the provision by the clearing manager of invoices to purchasers, and the production of purchaser invoices to generators, thereby creating an obligation on purchasers to pay the clearing manager and an obligation on the clearing manager to pay generators.
- 14.50 The rules draw heavily from the clearing and settlement rules that previously existed within NZEM. These rules were the subject of an application to the Commerce Commission in 1996 (Decision 280). In that decision the Commission declined jurisdiction to consider the authorisation application.
- 14.51 Part H also contains rules relating to prudential requirements. Commodity markets typically require buyers in that market to provide a form of security so that the market can be confident that the debts incurred by the buyer will be met at the time of settlement. With well over \$1 billion of electricity expected to be traded pursuant to the Arrangement every year, the integrity of the market requires buyers to meet prudential requirements. These requirements are outlined in Rule 2 of Section H.
- 14.52 Before someone is admitted as a purchaser under the rules, they must either:
- (a) maintain the equivalent of a bank grade credit rating;
 - (b) provide a cash deposit in an amount required by the clearing manager;
 - (c) provide a guarantee, letter of credit or bond from a party that maintains a bank grade credit rating; or
 - (d) lodge a hedge settlement agreement with the clearing manager.
- 14.53 In essence, purchasers of electricity are obliged to provide prudential cover totalling slightly more than the amount which would be outstanding at the time settlement is made each month. The clearing manager is charged with responsibility for the collection, holding and monitoring of prudential requirements.
- 14.54 An important element of Part H is the formation of contracts between participants in the trading arrangements of the Rulebook. Rule 6 provides for contracts between

generators and the clearing manager, and between the clearing manager and purchasers for the sale and purchase of electricity respectively. The clearing manager prepares invoices for generators and purchasers, and is responsible for collecting the amounts owing from purchasers and paying generators.

- 14.55 Rule 10 deals with a default situation where someone fails to pay the amount due under the rules. This default provision is a fairly standard default provision, except that it involves an interaction between the clearing manager, the person in default, and the Rulings Panel. It may, if the default remains outstanding, lead to the appointment of a receiver and manager over all or any part of the defaulter's business. Unlike many other commodities where a failure to pay can result in the withdrawal of service, no provision has been made in these rules for defaulters to have their electricity cut off. The Rulebook recognises that cutting off electricity (except for individual customer disconnection for non-payment) is a severe measure, and not politically acceptable in New Zealand. For these reasons, different remedies are required for defaulters, including the ability to appoint a receiver and manager if need be.
- 14.56 Fees and other payments made by members are also described in Part H. These fees are allocated to members in accordance with the provisions of Schedule A7, generally on a user pays basis. A quirk of electricity markets is that there is in fact a difference between the amounts that are paid by purchasers for electricity and amounts received by generators. This is primarily because electricity "leaks" while being transmitted, so that the amount of electricity received by purchasers is less than the amount inputted by generators. The difference between the amount paid by purchasers and the amount received by generators is known as a "loss and constraint excess". This excess is paid to grid owners and, in part, essentially represents a variable transmission fee.

Part I - Implementation and transition issues

- 14.57 Part I provides for the transition from the NZEM and MARIA trading arrangements to the trading arrangement of the Rulebook. This Part contains a number of provisions to address issues arising from the termination of the existing codes and the establishment of the new multilateral arrangement. These rules include administrative provisions which provide for the transfer of interim membership applications, and the transfer of information and records.
- 14.58 Part I also includes rules which provide for the Industry EGB to take responsibility for any compliance issues arising out of the existing codes which are not resolved on the date the new rules become operational.
- 14.59 Other transitional arrangements provided for in this section include:

- (a) provisions allowing for the continuance of the GSC as a working group of the Industry EGB for a six month period;
- (b) a clause providing a grace period for inadvertent breaches of rules where the rules have changed from those in existing codes;
- (c) fast-track approval procedures for service provider contracts;
- (d) a provision granting certain purchasers a transitional exemption from bid offer requirements; and
- (e) provisions relating to a "must run" dispatch auction derived from existing NZEM arrangements.

14.60 There are also a set of rules designed to give effect to the Transitional Dispensation Agreement. Part I also includes provisions which allocate rule development costs incurred under the existing codes.

MARKET AND COMPETITION CONSIDERATIONS

15. INTRODUCTION

15.1 The Applicant considers that the arrangements in Section IV, Part A of the Rulebook which dictate the amount to be charged for services to a non-member constitute a breach of section 30 of the Act (see paragraph 24.22), but that the Arrangement does not otherwise contravene any of sections 27, 29 or 30 of the Act. However, it recognises that the Commission, or some other person, may take the view that these sections apply to aspects of the Arrangement. Given the identified breach of section 30 and the importance of the Arrangement to the electricity industry and the country as a whole, there is a need to ensure, so far as practicable, that it will be immune from challenge under the Act. Thus, in terms of sections 58(1), 58(2), 58(5) and 58(6) of the Act, the Applicant applies for an authorisation on the basis that it wishes to enter into and give effect to the Arrangement. As discussed above (see paragraph 6.4), the Applicant recognises that the Authorisation should only extend to those provisions of the Arrangement which give rise to the characteristics set out in paragraph 22.3, and described more fully in sections 22 to 29 of this application.

- 15.2 The Applicant seeks an authorisation on the ground that the benefits to the public resulting from the Arrangement will, in all the circumstances, be likely to outweigh the lessening in competition that would be likely to result from the Arrangement.

16. MARKET ANALYSIS

- 16.1 The Commerce Act defines a "market" as being a market in New Zealand for goods and services as well as other goods and services that, as a matter of fact and commercial common sense, are substitutable for them. To determine the extent of a market, regard must be had to the areas of close competition. A market has dimensions of product, geography, functional level and time.

- 16.2 In terms of product, the Applicant considers that it is appropriate to consider electricity separately from other forms of energy. Possibilities exist at the margin to substitute electricity supplied through the national grid with other forms of energy, such as gas, coal or oil. However, the Applicant submits that the appropriate boundary for analysis is the market for electricity and not the market for all forms of energy in New Zealand, since they are not directly substitutable. This is consistent with the Commission's approach in Decision 435 (Natural Gas Corporation Holdings Limited and AGL NZ Energy Limited, 8 June 2001) and Decision 387 (Natural Gas Corporation Holdings Limited and TransAlta New Zealand Limited, 17 March 2000). In Decision 387 the Commission commented that the price of gas has an influence on the cost of electricity, because it is used in the production of electricity. However, the Commission concluded (paragraph 42):

However, the Commission remains of the view at this time that there is insufficient substitutability between electricity and gas to place the two energy forms in the one market. From information received during the course of the investigation of the current application, the Commission does not consider that a small, say five percent, increase in price of one energy form for a period of, say, one year would result in sufficient switching to the other energy form to make the price increase unprofitable.

- 16.3 The Applicant submits that this approach remains applicable and that the relevant product market is electricity.

- 16.4 A number of functional markets can be identified in relation to the product market for electricity. The functional electricity markets relevant to the application are:

- (a) The wholesale market for electricity, which includes the generation and purchase of electricity;

- (b) Transmission and distribution of electricity;
- (c) The retail market for electricity;
- (d) The provision of ancillary services. The main ancillary services are instantaneous reserve, frequency control reserves, over-frequency arming, voltage support, and black start; and
- (e) Other services. This category includes all other services which are necessary for the functioning of the wholesale market. This category contains several markets, including the market for administration services, the market for pricing services, the market for clearing services, the market for system operator services, the market for reconciliation services, the market for registry services and the market for meter services.

16.5 Each market has particular geographical and temporal elements. In general, the Applicant submits that the Arrangement impacts on the electricity industry as a whole and affects all functional markets at a nationwide level, since it specifies rules for the functioning of the trading market in New Zealand as a whole. The Applicant acknowledges that there may be some issues surrounding the definition of markets, such as whether the retail market can be divided into regional markets (see discussion in paragraph 16.10), or whether ancillary services are part of the market for electricity (see paragraph 16.16). However, the Arrangement affects all markets irrespective of the functional or geographical division. Significant refinement of market definitions is not necessary as the impacts of the Arrangement are likely to be very similar to that under the counterfactual, irrespective of market definition.

16.6 The Applicant submits that, subject to a small number of qualifications noted below, the markets should, for the purposes of this application, be treated as nationwide markets in terms of their geographical extent. This is consistent with the approach of the Commission in Decision 369 (MACQS, 13 August 1999), where the Commission stated that the markets were national in scope because the arrangement the subject of the application impacted on the electricity sector throughout the country.

16.7 Each market or category is now discussed in turn.

Wholesale market for electricity

16.8 This is a nationwide market, since generators from across the country may contribute electricity to the pool through the national grid, and purchasers may take electricity from the pool by way of the national grid. The Applicant considers that generation is part of

the wholesale market, since generation is the supply side of the wholesale market and the purchase of electricity on the market is the demand side of the market. These two elements together comprise a single market. The current codes and the Rulebook provide for half hour bids and offers, thereby dividing this market, temporally, into 48 separate markets over the course of the day.

Transmission and distribution of electricity

- 16.9 Transmission of electricity is a national market since the national grid transverses the country. The distribution market, on the other hand, consists of several distinct markets (approximately thirty markets, there being approximately thirty lines companies), each bounded by the extent of the local distribution network. While there are some situations in which the transmission and distribution markets overlap due primarily to the fact that some customers have the choice of either directly connecting to the national grid, or to their local distribution network, the Applicant submits that transmission and distribution of electricity constitute separate markets. If the price of transporting electricity around the country rises, distributors with a local network are unable to enter the national transmission market or another local distribution market as they are restricted to the extent of their local network.

Retail market for electricity

- 16.10 The Applicant submits that the retail electricity market is a nationwide market, as it is expected that if a retailer in any region were to impose a small yet significant and non-transitory increase in price (ssnip) other retailers would move to enter that region to take advantage of the profits to be made.
- 16.11 The Applicant recognises that there have been suggestions that the retail electricity market is becoming regionalised. In a memorandum to the NZEM on 17 July 2001 the Market Surveillance Committee commented that a possible consequence of permanent and economically unjustifiable incidental transmission constraints is regionalisation of electricity markets as a result of which the bulk of a firm's customers and generation are located in the same region by reason of constraints and/or location factors which cannot be managed from a financial perspective.
- 16.12 Although some market players may be focussing on particular regions, this does not mean that the markets are necessarily regionalised from an economic or competition law perspective.
- 16.13 The Applicant submits that constraints are not such as to limit the ability of retailers to enter other markets; if the price of electricity rises in one region, retailers in other regions

will likely move to enter that region. Constraints occur only in a small proportion of trading periods, and are not such as to restrict the ability for a new entrant to enter and compete in any particular region to any significant degree. The main risk for retailers is in not having hedges to manage the wholesale price of electricity, as observed in the electricity crisis this year. It is less important for retailers to be located near supply.

- 16.14 The Applicant submits that resolution of this issue is not essential to this application as the Arrangement impacts on the entire electricity market in New Zealand, as was found in Decision 280 (the NZEM pricing decision). Even if regional retail markets were found to exist, the Arrangement would apply in the same manner to each such regional market as to the national market discussed in this Application.
- 16.15 The Applicant, accordingly, submits that the retail market should be considered to be a nationwide market for the purposes of the present application.

Provision of ancillary services

- 16.16 The requirement for instantaneous reserves, frequency control reserves and over-frequency arming (South Island only) are typically determined on an island basis. Other ancillary services such as voltage support are required on a regional basis. The size of these regions varies, based on overall supply and demand and regional grid capabilities. Currently cost allocations are based on four regional zones (three in the North Island and one in the South Island). In summary, we conclude that the following geographical markets apply to ancillary services:

Product Market	Geographical Markets
Instantaneous reserves	National
Frequency control reserves	National
Over-frequency arming	South Island only
Voltage support	Regional zones

- 16.17 Ancillary services could be considered to be in the same market as electricity because generators offer to provide both instantaneous reserves or electricity, although this is not the case for all ancillary services (such as voltage support or blackstart). However, a change in the price of instantaneous reserves has an insignificant impact on the demand for electricity. This suggests that these products are in separate markets. The Commission accepted this in Decision 369 (MACQS), where it recognised that the price of instantaneous reserves had no obvious impact on the demand for electricity. In

addition, each ancillary service occupies a separate market since ancillary services are not practically substitutable for one another and therefore the price of one has no effect on the supply or demand for another.

- 16.18 Temporally, the market for instantaneous reserves is the same as the markets for electricity (48 separate, half hour markets each day). However, the other ancillary services are typically procured on a monthly or annual basis.

Other services

- 16.19 Due to the interconnected nature of the electricity industry, services are needed to ensure that the market operates effectively. Services such as clearing, pricing, market administration, reconciliation, system operation, and metering are included in this category. These services are provided to the electricity industry so that the industry can function in a competitive environment. These services comprise separate markets because they each provide distinct services which cannot be substituted for each other or for other services. Even if some of these services were combined, it would not affect the analysis. Each of the markets is necessarily nationwide because the wholesale market operates on a single nationwide basis. However, it is unnecessary to finely divide this category into individual markets for the purposes of this application.

17. COUNTERFACTUAL

- 17.1 To assess the competitive effects of the Arrangement, in considering both whether the Arrangement may breach any Part II provisions of the Commerce Act, and, if so, whether there is a net public benefit such as to justify an authorisation, it is necessary to have regard to the counterfactual.
- 17.2 In assessing the purpose and effect of the Arrangement under sections 27, 29 and 30, and in assessing whether the public benefits of the Arrangement are likely to outweigh any detriments, the appropriate analysis is a "with" and "without" comparison, rather than a "before" and "after" comparison. A benchmark is required to make this assessment. This benchmark is the counterfactual: the best objective assessment of the most likely alternative scenario, and represents what would likely otherwise happen in the absence of the trade practice.

NZEM pricing authorisation decision (Decision 280)

- 17.3 In the NZEM pricing authorisation decision (Decision 280), the Commission concluded that the counterfactual to the proposed real time market (similar to the market arrangements contained in the Rulebook) was the situation where most electricity is

traded by way of bilateral contracts individually negotiated, where overs and unders are traded through a pool set up and administered by Transpower, and where all players are required to enter into a physical allocation agreement administered by Transpower.

- 17.4 In reaching this conclusion, the Commission had regard to a policy statement of the Government of 8 June 1995 in which the Government said that "pooling arrangements should be developed in response to market need, with a balance of interests involved in the development of any rules, so that the outcomes are neutral and efficient". The Commission interpreted this as requiring that the counterfactual must be acceptable to different interests in the market. The Commission also commented in the NZEM decision (paragraph 100):

The authorisation process is not intended to allow the Commission to fine tune particular proposals by, for instance, rejecting all applications until one is received which matches in detail the counterfactual arrangement which it finds the most appealing. Accordingly, the Commission believes that it is appropriate that the counterfactual it adopts be expressed in general terms, and that these terms describe what is pragmatically and commercially likely in the absence of the proposed arrangement.

- 17.5 These comments were made in the context of a discussion that the Commission should either accept or reject the arrangement in its entirety and should not attempt to adopt variations of the proposal as the counterfactual.

MACQS authorisation decision (Decision 369)

- 17.6 In the MACQS authorisation decision (Decision 369), the Commission considered that the appropriate counterfactual was one in which the parties would strive to obtain a consensus on an alternative arrangement for collectively determining elements of common quality. The Commission stated that it did not believe that any single alternative arrangement to that proposal would have the necessary support of relevant parties to allow it to be readily implemented (paragraph 91):

The Proposal has been drawn up only after extensive and apparently difficult negotiating sessions involving concessions and trade-offs by all parties. While the Proposal does not have unanimous support, the IGSC has achieved a level of consensus. A similar level of consensus would be needed before an alternative could be put in place.

- 17.7 The Commission considered that in time a reasonable consensus would be reached, and that the consensus would likely replicate much of the MACQS proposal, but with any specific concerns expressed by the Commission addressed.

- 17.8 The Commission accepted that there was strong pressure for a change from the status quo and that this meant that over time the industry would reach a consensus and the agreed arrangement would likely replicate MACQS. The Commission also recognised that pressure for change from the status quo would continue to come from the Government. The Commission had regard to the Government's policy statement where the Government stated that grid users should be responsible for selecting the quality and quantity of services for which they are willing to pay. The Commission considered that pressures would force the parties to agree on alternative arrangements. The Commission did not express how these alternatives would differ from the proposed arrangement however, commenting (paragraph 97):

The Commission is not in a position to specify with any certainty how details of the alternative arrangements may vary from the Proposal which is the subject of the application. To meet the guiding principles, it is likely that they will involve collective decision making, although voting rights may vary from those in the Proposal in a way which it is not possible to determine at this stage.

- 17.9 A significant difference between the MACQS proposal and the counterfactual in relation to this application relates to timing. In the MACQS case, there was no particular time pressure to constrict the development of an alternative industry arrangement. However, in the present situation political pressures, particularly pressure from the Minister of Energy, mean that there is little, if any, further time to develop an industry-led alternative to the Rulebook.

Number Administration Deed authorisation decision (Decision 356)

- 17.10 In Decision 356 relating to authorisation for the entry into and giving effect to the Number Administration Deed dated 17 May 1999 ("**NAD Decision**") the Commission considered whether to grant an authorisation for the Number Administration Deed ("**NAD**"), which broadly provided for allocation of numbers and number portability. The Commission declined jurisdiction in relation to section 27 of the Act, determining that the NAD did not substantially lessen competition. The Commission did conclude, however, that section 29 of the Act applied to the NAD and granted an authorisation for the NAD to the extent that it breached section 29.
- 17.11 Part of the factual matrix surrounding the NAD application included a Government policy statement dated 18 December 1998 in which the Government outlined its overall policy objectives for telecommunications numbering. In that statement the Government stated that telecommunications number portability must be available between telecommunications networks.

17.12 The Commission concluded that the appropriate counterfactual was a regulated solution with the regulations substantially mirroring the provisions of the NAD. The Commission had regard to a statement of the Ministry of Commerce that if the NAD was not able to proceed, the Ministry's advice to the Minister of Communications would likely be that "the Government should pass empowering legislation to enable a numbering mechanism with the characteristics of the Number Administration Deed to be established by regulation". The Commission noted that the Minister of Communications had stated his expectation that the provisions of the regulations would be very similar to the provisions in the NAD. The Commission also took notice of the fact that the Government had indicated that it considered the status quo unacceptable and that telecommunications numbering resources must be independently administered and allocated and number portability available when required.

17.13 The other factors taken into consideration by the Commission included:

- (a) New service providers unanimously believed that independent number administration in the manner proposed by the NAD was desirable, irrespective of the type of number portability adopted;
- (b) There was strong support for number portability from new service providers, telecommunication users, other consumer groups, the Government, and political parties;
- (c) Telecom stated that it was persuaded to agree to some elements of the NAD because it wanted to avoid the regulatory alternative, which it considered was a very real alternative;
- (d) Telecom considered that the NAD was part of a package and it would be unlikely to agree to an alternative arrangement which imposed greater costs or risks on Telecom;
- (e) Vodafone stated that it would not voluntarily enter an arrangement for determining and paying for an appropriate number portability solution unless all other service providers were similarly committed;
- (f) The Government had indicated a preference to rely on the Commerce Act rather than industry specific regulations to address competition concerns; and
- (g) Any regulation would require empowering legislation, and there was little opportunity for this in 1999.

17.14 The Commission considered that there were two possible alternative scenarios for numbering administration:

- (a) Status quo counterfactual. Vodafone submitted that, in the absence of the NAD, bilateral negotiations would take place because of the difficulty of designing and implementing an appropriate regulatory regime; and
- (b) Regulated solution scenario. The Commission considered that there would be strong pressure for independent number administration and for a more efficient number portability method than was currently in place.

17.15 The Commission concluded that a regulated solution was the most likely alternative scenario in the absence of the NAD. The regulations implemented would, in the Commission's opinion, most likely mirror the provisions of the NAD. This view was based on comments by the Ministry of Commerce and the Minister of Communications (see paragraph 17.12). The Commission stated (paragraph 169):

Nothing provided to the Commission has suggested that independent number administration and a more efficient number portability method will be achieved in the absence of the Deed except by Government intervention. Based on the advice of Government officials, the Commission considers that such intervention is likely to be by way of regulation. It is recognised that such regulations would impose costs on the economy. However the Commission is of the view that the Government is likely to consider that the benefits which can be achieved from the stated goals will justify these costs.

The counterfactual in the present case

17.16 As with consideration of the NZEM counterfactual, it is necessary to take into account political considerations when determining the appropriate counterfactual for the Arrangement. The Applicant submits that the regulatory counterfactual is the most likely alternative scenario should the industry fail to achieve an agreed (and authorised) set of rules. This regulatory counterfactual would involve the Governor General, on the recommendation of the Minister, making regulations to establish the Crown EGB, and then making regulations or rules to establish appropriate rules for the industry. The principal objective of the Crown EGB would be to ensure that electricity is generated, conveyed, and supplied to all classes of consumers in an efficient, fair, reliable and environmentally sustainable manner (section 16 of the Electricity Amendment Act 2001 inserting section 172N of the Electricity Act 1992).

17.17 The Crown EGB would have the power to recommend regulations and rules to the Government, and would establish and operate markets for industry players, including

developing best practice distribution pricing methodology and other standards and agreements. The regulations will likely establish a compulsory market arrangement. It is in the nature of regulations that they are mandatory, and it is important for the operation of the electricity market that there is a single co-ordinator. In addition, the mandatory nature of rules providing for common quality and security of the system is consistent with the GPS which provided (paragraph 9, Folder of Supporting Material, number 7):

Compliance with the rules will be compulsory for generators, distributors, retailers, directly connected end users and Transpower, to the extent that they are applicable to these parties, and to the extent necessary to give effect to Government policy in this Government Policy Statement.

17.18 Regulations and rules would be introduced by the Government to provide for the establishment and operation of wholesale markets for electricity, including:

- (a) Pricing and determining quantities of electricity for market transactions;
- (b) Clearing, settling, and reconciling market transactions;
- (c) Scheduling and dispatching electricity;
- (d) Disclosure of market information;
- (e) Minimum prudential standards for market participation; and
- (f) Minimum standards of market conduct.

(Section 16 of the Electricity Amendment Act 2001, inserting section 172D into the Electricity Act 1992)

17.19 The Applicant submits that the Crown EGB would recommend rules largely similar to those in the Rulebook as the regulations under which the industry would operate for the following reasons:

- (a) The Government has indicated its desire to see evolution of the current codes preferably through a contractual solution implemented by the industry. In the GPS the Government stated that a new governance structure with a single Electricity Governance Board should be established to replace the existing governance arrangements of NZEM, MARIA and MACQS;

- (b) The Arrangement represents agreement between industry players and represents an evolution of the self-governance arrangements of the industry by combining NZEM, MARIA and MACQS;
- (c) The Rulebook represents the rationalisation of MARIA, NZEM and MACQS. However, the Rulebook changes the market structure by moving from a hybrid market which permitted trading parties discretion as to whether to use NZEM either as a gross pool (those who trade exclusively through NZEM) or as a net pool (those who trade partly through MARIA). Under the new structure, all parties must use the gross pool but may replicate the financial aspects of bilateral transactions through financial arrangements. The rules are therefore likely to function efficiently and the market will not malfunction. This would be politically desirable for both the Crown EGB and the Minister of Energy; and
- (d) The Crown EGB, when established, would be under pressure to implement regulations to govern the industry. For this reason, it is likely that the Crown EGB would, as a starting point, adopt existing rules for the industry or at least rules which are broadly acceptable to the industry as a whole. These rules are likely to largely mirror the Rulebook, since the Rulebook fulfils the Government's requirements. There would, of course, be some amendments to the Rulebook prior to adopting it for regulation. In particular, the governance arrangements and rule change mechanisms will necessarily be different in the case of the Crown EGB than is the case with the Industry EGB.

17.20 This regulatory counterfactual is supported by the Electricity Amendment Act 2001 which was born out of the GPS, where the Government indicated its intention to regulate should the industry fail to agree on appropriate rules; there will be no second chances. In the GPS, the Government stated (paragraph 2, Folder of Supporting Material, number 7):

The Government favours industry solutions where possible, but is prepared to use regulatory solutions where necessary.

17.21 Regulation is even more likely than it was in the NAD application, in that Parliament has passed the Electricity Amendment Act 2001 and the Government can now move quickly to regulate if an industry-led solution is not implemented. This Act empowers the Governor General to make regulations, on the recommendation of the Minister, establishing the Crown EGB and implementing regulations for the operation of the industry. The Commission had noted in the NAD decision that a factor it took into account in determining whether a regulatory counterfactual was the most likely

alternative scenario in the event the NAD did not proceed, was that regulations would require empowering legislation to be introduced. In the current situation Parliament has clearly signalled its intention to impose regulation on the electricity industry should the industry fail to implement a contractual solution. Appropriate measures are in place to enable the Government to immediately impose regulation on the industry should a contractual solution fail to be achieved. This supports the Applicant's submission that the appropriate counterfactual is a regulatory counterfactual.

- 17.22 In addition, the Minister of Energy, in a statement to the Electricity Networks Association of New Zealand annual general meeting (29 October 2001, Folder of Supporting Material, number 9) commented on the progress of the Electricity Governance Establishment Project and stated:

The alternative to the new arrangements is not the existing arrangements; it is regulation. If the EGEP approach fails to get industry support, I will have no option but to establish a Crown entity Electricity Governance Board and rules in a wide range of areas.

I believe that the contractual approach and industry self-governance have important advantages over regulation. Contractual arrangements are likely to be more flexible and responsive than a regulatory approach. It is also quite likely to be cheaper.

- 17.23 In summary, the Applicant considers that the most likely alternative scenario, should the Arrangement not become operational, is that the Government will regulate to provide rules for competition in the electricity industry under the Electricity Amendment Act 2001. The Government would establish the Crown EGB, which would recommend to the Minister the current Rulebook as the basis for appropriate rules for the industry, with the exception of consequential modifications to the governance arrangements in Part A.

PART II ANALYSIS

18. INTRODUCTION

- 18.1 The following sections discuss the general principles applicable to sections 27, 29 and 30 of the Act.
- 18.2 As a general point, the Applicant submits that rules are not inherently anti-competitive, but may actually promote competition. In *Chicago Board of Trade v United States* (1918) 246 US 231, Justice Brandeis considered a rule imposed on the grain market by

the Chicago Board of Trade prohibiting members from purchasing or offering to purchase during the period between the close of the market and the opening of the session on the next business day at any price other than the closing bid of the market. The Department of Justice alleged that such a rule was anti-competitive, resting on the argument that a rule or agreement by which men occupying positions of strength in any branch of trade fixed prices at which they would buy or sell during an important part of the business day is necessarily anti-competitive.

18.3 Justice Brandeis disagreed, stating:

But the legality of an agreement or regulation cannot be determined by so simple a test, as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts.

18.4 Justice Brandeis held that the rule was justified and did not restrain trade in any way.

18.5 The Government has recognised that rules are required for the industry to function efficiently and has provided the industry with incentives to develop its own rules, before it regulates. The test of these rules, for the Commission to determine in this application, is whether the rules regulate and thereby promote competition, or whether they harm competition.

18.6 Rules are necessary for competition in the electricity industry, as evidenced by the history of the market, described above. New Zealand has sought to open up the range of ownership options and to increase competition where possible. Electricity is essential for a modern society and an efficient electricity industry can provide benefits to a modern society due to reduction in operating costs. Fifteen years ago the electricity industry in New Zealand was a single government-owned generation and transmission system, with local publicly owned distributors and retailers. There was no competition at any point in the supply chain. Today, while both transmission and distribution remain natural monopolies, there is competition in the generation and retail sectors. Because of the unique characteristics of the electricity industry, rules are needed so that competitors can interact effectively and efficiently. These rules are currently provided by NZEM and

MARIA, but as described above, the industry and the Government would like to see these rules, together with the operational rules developed under MACQS, rationalised.

19. SECTION 27

19.1 Section 27 of the Commerce Act prohibits the entering into, or giving effect to, contracts, arrangements or understandings that have the purpose, effect or likely effect of substantially lessening competition.

19.2 Section 27(1) states:

No person shall enter into a contract or arrangement, or arrive at an understanding, containing a provision that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market.

19.3 In assessing whether there has been a substantial lessening of competition in a market, it is necessary to assess the nature and extent of the market, the probable nature and extent of competition that would exist but for the conduct in question, and determine whether what is left represents a substantial lessening of competition (*Dandy Power Equipment Pty Limited v Mercury Marine Pty Limited* (1982) ATPR 40-315).

19.4 In determining whether there has been a substantial lessening of competition regard can be had to any efficiencies that would arise from the conduct, even before considering the net public benefit test for an authorisation. In *Shell (Petroleum Mining) Co Ltd v Kapuni Gas Contracts Ltd* (1997) 7 TCLR 463 at 528 the High Court recognised a "trend for efficiencies to be considered in terms of their pro-competitive effect". After considering the law on this issue in Australia, the United States, and New Zealand, the Court found that (at 531):

...this leaves us in a position where when considering the effect of the contract on competition we can have regard to any efficiencies which are in our view, pro-competitive even though we do not have any authorisation public benefit issues before us.

19.5 The High Court in *Clear Communications Ltd v Sky Network Television Ltd* (Gallen J and Dr M Brunt, 1 August 1997, CP19/96, High Court Wellington,) also considered the relevance of efficiencies to a section 27 analysis. At issue, among other things, was Clear's claim that section 27 would be breached if Telecom expanded into pay television. Clear argued that any efficiencies of economies of scale and scope arising from Telecom's conduct were not relevant to proceedings regarding a possible breach of section 27 as the authorisation process was the appropriate vehicle for dealing with such claims. In rejecting this argument, the Court stated at p 67:

It is true that the availability of authorisation on the basis of efficiencies means that there is some tension in the partitioning of standards between the prohibitions contained in Parts 2 and 3 of the Act and the availability of authorisations. The emphasis in Australian and New Zealand jurisdictions when dealing with such concepts as 'dominance', 'market power', 'lessening of competition' is upon discretionary power and barriers to entry, 'the power to give less and charge more'. *Re Queensland Co-op Milling Association Ltd; Re Defiance Holdings Ltd* 1 ATPR 40-012, 17,247. Yet 'competition is a process rather than a situation' (17,246) that may well express itself in ongoing efficiencies as well as other aspects of market performance.

...

Section 27 is couched in terms of both 'purpose' and 'effect'. Where the effect of Telecom's expansion into pay TV may well be the achievement of economies of scale and scope, that in itself can simply be viewed as an element in a long run dynamic, competitive process. Clear's propositions were largely in terms of 'effect', but as to 'purpose', if Telecom's purpose is to expand its business into complementary products, achieving in the process economies of scale and scope, it cannot be said to be pursuing an anti-competitive purpose ...

- 19.6 The Applicant therefore submits that the Commission can validly take into consideration pro-competitive efficiencies in determining whether the Arrangement potentially breaches Part II of the Act. Where there are sufficient pro-competitive efficiencies it is possible to find that there is no breach of Part II of the Act.

20. SECTION 29

- 20.1 Section 29 of the Commerce Act prohibits the entering into, or giving effect to, a contract, arrangement or understanding containing an exclusionary provision. An exclusionary provision is a provision of a contract or arrangement between persons any two or more of whom are in competition with each other, and that provision has the purpose of preventing, restricting or limiting the supply of goods or services to, or the acquisition of goods or services from, any particular person or class of persons which is in competition with one or more parties to the contract or arrangement, by all or any of the parties to the contract.
- 20.2 The Commerce Amendment Act 2001 inserted section 29(1A), which provides that a provision of a contract or arrangement that would otherwise be an exclusionary arrangement is not exclusionary if it can be proven that the provision does not have the purpose, effect or likely effect of substantially lessening competition.
- 20.3 Section 29 now provides:

(1) Subject to subsection (1A), for the purposes of this Act, a provision of a contract, arrangement, or understanding is an exclusionary provision if—

(a) It is a provision of a contract or arrangement entered into, or understanding arrived at, between persons of whom any 2 or more are in competition with each other; and

(b) It has the purpose of preventing, restricting, or limiting the supply of goods or services to, or the acquisition of goods or services from, any particular person, or class of persons, either generally or in particular circumstances or on particular conditions, by all or any of the parties to the contract, arrangement, or understanding, or if a party is a body corporate, by a body corporate that is interconnected with that party; and

(c) The particular person or the class of persons to which the provision relates is in competition with one or more of the parties to the contract, arrangement or understanding in relation to the supply or acquisition of those goods or services.

(1A) A provision of a contract, an arrangement, or an understanding that would, but for this subsection, be an exclusionary provision under subsection (1) is not an exclusionary provision if it is proved that the provision does not have the purpose, or does not have or is not likely to have the effect, of substantially lessening competition in a market.

21. SECTION 30

21.1 Section 30 of the Act provides:

(1) Without limiting the generality of section 27 of this Act, a provision of a contract, arrangement, or understanding shall be deemed for the purposes of that section to have the purpose, or to have or to be likely to have the effect, of substantially lessening competition in a market if the provision has the purpose, or has or is likely to have the effect of fixing, controlling, or maintaining, or providing for the fixing, controlling, or maintaining, of the price for goods or services, or any discount, allowance, rebate, or credit in relation to goods or services, that are—

(a) Supplied or acquired by the parties to the contract, arrangement, or understanding, or by any of them, or by any bodies corporate that are interconnected with any of them, in competition with each other; or

(b) Resupplied by persons to whom the goods are supplied by the parties to the contract, arrangement, or understanding, or by any

of them, or by any bodies corporate that are interconnected with any of them in competition with each other.

(2) The reference in subsection (1)(a) of this section to the supply or acquisition of goods or services by persons in competition with each other includes a reference to the supply or acquisition of goods or services by persons who, but for a provision of any contract, arrangement, or understanding would be, or would be likely to be, in competition with each other in relation to the supply or acquisition of the goods or services.

21.2 Section 30 is, therefore, a deeming provision. Once it has been proven that there has been a contravention of section 30, the conduct is deemed to have substantially lessened competition in a market.

21.3 Section 30 deems price fixing arrangements to contravene section 27 regardless of whether or not they have any anti-competitive purpose or effect. The Commission has considered section 30 in Decision 280 relating to the authorisation of the NZEM pricing rules. At paragraph 133, the Commission restated the section 30 issue as follows:

There are . . . two key issues which must be addressed in considering whether section 30 applies:

(a) Do the provisions constitute a contract, arrangement or understanding between actual or potential competitors?

(b) If so, do they have the purpose or effect or likely effect of fixing or controlling or maintaining prices?

21.4 The Commission considered that the second issue required close consideration of the meanings of the words "fix", "control" and "maintain". The Commission focused on *Radio 2UE Sydney Pty Limited v Stereo FM Pty Limited* (1983) ATPR 44,398, the leading Australian case on the equivalent Australian provisions, where the words "fix" and "maintain" were taken to have their ordinary dictionary meaning. This case has been adopted in New Zealand in *Commerce Commission v Caltex New Zealand Limited* [1998] 2 NZLR 78. *Radio 2UE* suggested that some element of certainty (as to the level of price) is required for fixing, controlling or maintaining of price to be established. The Commission quoted the Full Federal Court's view that:

The word "fixing" in section 45A takes colour from its general context and from the words used with it - "controlling or maintaining" - and not every determination of a price, following discussion between competitors, will amount to a price "fixing". There must, we believe, be an element of intention or likelihood to affect price competition before price "fixing" can be established.

This will often be a matter of inference, requiring no direct evidence for it to be established.

- 21.5 The Commission adopted the same approach to the definition of "control" as it had taken in *Insurance Council of New Zealand (Inc)* (Decision 236) where it had interpreted the phrase "fix, control or maintain" as follows:

The terms "fix", "control" and "maintain" are synonymous with an interference with the setting of a price, as opposed to allowing such price to be set in response to changes in the supply and demand for goods and services. Thus, in a technical sense any agreement by competitors in a market which has an influence on, or interferes with the setting of a price, amounts to "price fixing". However, following Lockhart J [In the *Radio 2UE* case] for that interference to have any significance in a competition sense, the price that is fixed must not be "instantaneous or merely ephemeral, momentary, or transitory or be the result of arrangements which merely incidentally affect it".

- 21.6 The Commission cited its conclusion from the *Insurance Council* case that:

Section 30 only applies to price fixing **in a competitive sense** and that it is not sufficient for the provision under consideration merely to influence price.

(Emphasis in original)

- 21.7 It further noted that in the *Radio 2UE* case the Court had suggested that "some element of certainty (as to level of price) is required for fixing, controlling or maintaining price".

CHARACTERISTICS OF THE ARRANGEMENT FOR WHICH AUTHORISATION IS SOUGHT

22. INTRODUCTION

- 22.1 This section considers the effect of the Arrangement on competition in the markets described above. For the Commission to grant an authorisation to a practice which may contravene one or more of the provisions of Part II of the Act, the Commission must first be satisfied that the practice in question breaches one of the provisions of Part II. If not, then the Commission has no jurisdiction to consider the authorisation application. The Applicant submits that most of the characteristics discussed do not contravene the provisions of Part II. However, the Applicant accepts that the arrangements in Section IX, Part A which dictate the amount to be charged for services provided to a non-member constitute a breach of section 30, but submits that this is a "technical breach".

Therefore, the Applicant seeks an authorisation of the Arrangement on the basis that it contravenes section 30 of the Act. In relation to sections 27 and 29 of the Act, the Applicant submits that the Commission should decline jurisdiction, on the basis that the Arrangement does not contravene either of these provisions.

22.2 The Applicant has identified characteristics of the Arrangement which it considers may contravene sections 27, 29 and/or 30. As discussed in paragraph 6.4, the Authorisation would not cover any breaches of the Act under provisions of the Arrangement unrelated to these characteristics.

22.3 The characteristics identified by the Applicant which it might be claimed contravene sections 27, 29 and/or 30 are:

- (a) The comprehensive coverage of the Rulebook;
- (b) Price determination processes;
- (c) Uniform standards;
- (d) Performance assurances;
- (e) Transmission service definitions and transmission investment;
- (f) Cost allocation; and
- (g) Information disclosure requirements.

22.4 Each is discussed in turn.

23. COMPREHENSIVE COVERAGE OF THE RULEBOOK

Introduction

23.1 The intent of the Arrangement is for all industry players in New Zealand's wholesale electricity market (that is, generators, distributors, retailers, directly connected end-users and grid owners) to be members of the Rulebook. The Rulebook also envisages that consumers may become members of Part C, and may also have votes allocated for the purposes of voting on the directors of the Board. This approach has been taken in order to minimise the risk associated with the co-ordination of the generation and transmission of electricity, prevent free-riding on the market created by the Arrangement, and bring about efficiencies through a single governance structure.

- 23.2 The Rulebook provides a standard set of trading arrangements pursuant to which the participants transact. By providing a set of common terms, it avoids the need to establish a myriad of bilateral agreements to address trading, quality, switching, transmission and service providers, inter-party liability, dispute resolution, payment systems and enforcement. If particular parties wish to alter the economic effect of those rules (for example, modify liability caps), they can do this through separate collateral contracts, which do not change the Rulebook, but which alter the rights between them to achieve the same effect.
- 23.3 In this section the Applicant addresses possible Commerce Act concerns relating to the comprehensive nature of the Rulebook under sections 27 and 29 of the Act. In particular, it could be argued that the Arrangement evidenced in part by the Rulebook is an exclusionary practice which prevents competing trading arrangements from emerging.
- 23.4 In assessing the competitive effects of the comprehensive single market, it should be noted that:
- (a) A compulsory market is also part of the Government's approach and therefore forms part of the counterfactual;
 - (b) The comprehensive nature of the Arrangement applies only to the physical market including common quality, dispatch, pricing and clearance. Purely financial transactions (such as hedges and contracts for differences ("**CFDs**")) can be freely entered into by industry players in any manner they choose. This allows arrangements which cannot generally be directly transacted through the market created by the Arrangement, such as bilateral trades, to be undertaken (rule 7, Part H). Furthermore, any generator or purchaser may apply to be exempt from some or all of the trading arrangements where this would result in a net public benefit (Rule 3, section I, Part G). This will allow alternatives to bidding, scheduling and dispatch procedures to develop should this be efficient; and
 - (c) It will also be possible for members to resign from the Rulebook to join appropriate alternative trading arrangements should such structures develop over time. It is submitted that the possibility of alternative structures would be unlikely if the Government regulates.
- 23.5 For these reasons, which are developed further below, the applicant submits that the comprehensive single market approach will not lessen competition in any market and that accordingly there is no contravention of sections 27 or 29.

Description

Introduction

- 23.6 It is intended that all industry players will be members of the Rulebook. As such, industry players will be subject to the substantive rules and the enforcement mechanisms in the Rulebook and will be bound to pay fees for the services supplied under the Rulebook, such as common quality, costs of governance (for example for the Industry EGB and the Rulings Panel), and the costs associated with the trading arrangement (such as the costs of the system operator and the other service providers). It is intended that the rules will not take effect unless all major industry players become members of the Rulebook.
- 23.7 There are four main reasons for the comprehensive single market approach.
- 23.8 First, market security is maximised by ensuring that interdependent tasks, such as the dispatch of generators and the maintenance of common quality standards, are centrally managed. Attempting to disaggregate these functions across more than one market arrangement would create co-ordination risks for security of electricity supply.
- 23.9 The comprehensive nature of the Rulebook also helps ensure the security of the system through information flows. For example, if a participant is outside the Rulebook, the system operator is likely to have little information about the participant and cannot accurately cater for that participant. This could result in significant expense for the industry, either because the participant threatens the security of the system or because the system operator is obliged to engage additional ancillary services to protect the system. In most industries, the system operator would refuse service to this industry player. However, this option is not available once a player is connected and taking service because of the political and social aspect of electricity supply.
- 23.10 Second, a comprehensive arrangement creates certainty as to the terms on which the parties are transacting. This is especially important given the interdependent nature of the industry. It also allows for rule changes to be made in a considered and timely fashion.
- 23.11 Third, economies of scale will result by bringing NZEM and MARIA within a single governance structure (see paragraph 4.6). There has been no attempt to quantify these economies of scale at present, as they depend, in part, on the service provider contracts which are still being negotiated. Further information can be provided if the Commission wishes.

- 23.12 Fourth, as previously described in paragraph 11.1, NZEM members currently pay for elements of the market structure created under NZEM, such as security, dispatch and common quality (as it is at present). However, NZEM then allows MARIA members to utilise the system operated by NZEM, although the MARIA participants do not directly contribute to the costs of these elements (MARIA members do, however, effectively pay a fee: unmatched demand or supply under MARIA arrangements is bought from the load following generator through NZEM at plus or minus 10% of the NZEM clearing price). To eliminate the ability of some parties to obtain the benefit of market services without fully paying for the benefits, the Rulebook effectively establishes a single multilateral trading market. Members of the Rulebook who belong to this market will share the costs of the structures and processes underlying that market.
- 23.13 For these reasons and to satisfy the Government's expectations of a compulsory set of rules (as set out below), a comprehensive approach has been taken by the industry. However, it should be noted that there are four significant qualifications to the compulsory nature of the Rulebook:
- (a) Members can enter into financial transactions such as hedges and CFDs which have the same economic effect as entering bilateral trading arrangements (see paragraph 13.5);
 - (b) Asset owners may obtain approvals for equivalence arrangements and dispensations from complying with the Rulebook requirements, particularly standards;
 - (c) Generators and purchasers may obtain exemptions from complying with all or some of the rules relating to bids and offers, and scheduling and dispatch contained in Part G; and
 - (d) Members can resign from the Rulebook and continue to participate in the industry providing that the Industry EGB is satisfied that acceptable alternative trading arrangements are in place (see paragraph 14.4).

Implementation

- 23.14 As the Rulebook is a voluntary contractual arrangement between its members, it is not possible to simply *stipulate* that all wholesale electricity industry players must join as this would not be binding on non-members. In order to create incentives designed to bring about the same result, section IX of the Rulebook provides that:

- (a) Members are required to contract with non-members on the same terms that services and benefits would be provided under the Rulebook, except in relation to price where members agree to charge non-members a premium over the price payable in accordance with the Rulebook (see paragraph 24.9). This premium reflects the additional transaction costs resulting from the contracting party not being a member of the Rulebook;
- (b) Participants who decide to provide services or benefits to non-members may do so only on the basis that the non-member is provided with all of the same services and benefits which would have been provided if the non-member was a member under the Rulebook. Before providing services the member must inform the non-member that services will be provided only on this basis;
- (c) If a non-member refuses to agree to a contract on the terms described above, the member must refuse to transact and the Industry EGB will seek quantum meruit recovery for any benefits or services received which could have been received under the Rulebook. Quantum meruit is a legal doctrine under which the provider of a service may seek payment of a fair price from the beneficiary of the service in the absence of a contract. Legal advice received by EGEC supports the view that a Court would look to the price paid by the members of the Rulebook in determining a fair price for the non-member to pay and would also take into account extra costs generated by virtue of the party not being a member of the Rulebook; and
- (d) The Rulebook imposes requirements on members wishing to resign. If a member submits a written notice of resignation, the resignation becomes effective on a date decided by the Industry EGB having regard to whether the member is under investigation, whether a suspension of trading is or should be imposed and whether any obligation remains outstanding. Where a member wishes to continue to participate in the electricity industry despite leaving the Rulebook, the Industry EGB will also have regard to whether acceptable alternative arrangements are in place (see paragraph 14.4). In any event, for two years following the effective date of its resignation, a member will still be subject to the jurisdiction of the Rulings Panel and the Industry EGB in relation to acts and omissions under the rules before the effective date of resignation, any proceedings that may have been instituted against the member prior to the effective date, or any order relating to the member made by the Rulings Panel or the Industry EGB. The purpose of these provisions is to ensure that by exiting the Rulebook, a resigning member does not evade any obligation which

could have the effect of putting the overall market in jeopardy. This is an important assurance for the remaining members.

23.15 The main rules which implement the comprehensive nature of the Rulebook include:

- (a) Rule 1, section III, Part A, which set the basis for admission of a generator, purchaser, distributor, grid owner or direct consumer as a member of the Rulebook;
- (b) Rule 2, section III, Part A, which provides that the Industry EGB will determine the effective date of resignation for a member who submits a notice of resignation to the Industry EGB. This will be influenced by whether the resigning member has acceptable alternative arrangements in place (if that resigning member is not exiting the industry). The resigning member will still be subject to the jurisdiction of the Rulings Panel and the Industry EGB for a further period of two years (for matters such as wash ups);
- (c) Rule 3, section III, Part A, which provides for automatic suspension and termination upon the occurrence of particular events;
- (d) Section IX, Part A, which requires members to contract with non-members on the same terms and conditions as they would contract with other members, but at a higher price to reflect the uncertainty and the additional costs incurred due to the unknown when contracting with non-members. If the non-member refuses to pay, the Industry EGB may bring an action for quantum meruit for the service taken;
- (e) Rule 7, section III, Part C, which provides for equivalence arrangements and dispensations;
- (f) Rule 3, section I, Part G, which provides for purchasers and generators to apply to the Industry EGB for an exemption from full compliance with the rules relating to bids and offers and scheduling and dispatch; and
- (g) Rule 5, section II, Part C, which prohibits the system operator from contracting contrary to the Arrangement.

Competition analysis

Introduction

- 23.16 It could be perceived that the comprehensive single market approach is in contravention of sections 27 and 29 of the Act:
- (a) In relation to section 27, it might be thought that competition could be lessened by restricting the ability of industry players to transact other than through the Rulebook; and
 - (b) In relation to section 29, the Applicant accepts that the Rulebook is a contract between competitors which contains provisions which have the purpose of restricting the supply of services to competitors or potential competitors other than on the terms of the Rulebook. Accordingly, section 29(1) of the Act applies. The Applicant, however, relies on section 29(1A) which provides that contractual provisions which do not have the purpose, effect or likely effect of substantially lessening competition in any market do not contravene section 29. As a result, section 29 gives rise to the same issue as the section 27 analysis.

Sections 27 and 29

- 23.17 In determining whether the comprehensive single market nature of the Arrangement has the purpose, effect or likely effect of substantially lessening competition in any market, the Arrangement must be measured against the counterfactual.
- 23.18 The Arrangement is intended to require all market players to belong to the market established by the Arrangement. The applicant submits that under the counterfactual the market rules would be compulsory for wholesale electricity industry players. The GPS provides that (paragraph 9, Folder of Supporting Material, number 7):
- Compliance with the rules will be compulsory for generators, distributors, retailers, directly connected end-users and Transpower, to the extent that they are applicable to these parties, and to the extent necessary to give effect to Government policy in this Government Policy Statement.
- 23.19 This reflected the recommendations of the Report to the Minister of Energy on the Inquiry into the Electricity Industry which provided (paragraph 139, Folder of Supporting Material, number 6):

The physical market encompasses the arrangements for the dispatch of electricity from generators to retailers. In our view, participation in the physical market **needs to be compulsory for all parties**, to ensure that:

- behaviour is regulated by the combined actions of all parties;
- all the relevant parties are involved or represented in the decision-making;
- difficult or contentious decisions are taken, and taken in a timely manner; and
- a co-ordinated and efficient approach is taken to issues that impact on different functional levels of the industry.

(Emphasis added)

23.20 The Applicant submits that the market created by the Government is likely to be compulsory for all industry players, in contrast to the Arrangement, which at least envisages the possibility of industry players acting outside the Rulebook or belonging to alternative arrangements.

23.21 Furthermore, the Rulebook does not prohibit bilateral trading undertaken through financial instruments such as price hedges, CFDs, options and futures. These financial instruments allow industry players to allocate risks associated with the market and to replicate transactions, such as bilateral trading.

23.22 In particular, the Rulebook contemplates that bilateral financial arrangements will be entered into and provides for these to be notified to the clearing manager, who will take them into consideration when calculating amounts due to generators or due from purchasers (rule 7, Part H). Therefore, using financial arrangements, parties will be able to replicate the effects of bilateral physical trades, which are currently provided for under MARIA.

23.23 The ability to conduct off-market financial transactions also reflects the intention of the Inquiry Report, where it was stated that (paragraph 138):

Financial instruments assist in mitigating the risk for participants but do not underpin the efficient physical delivery of electricity. The financial market and the development and trading of financial instruments (such as hedges and futures) are areas in which the NZEM and other financial service providers should compete.

23.24 The Applicant submits that it is at least as likely that markets for financial arrangements will develop under the proposed Arrangement as under the regulatory counterfactual.

- 23.25 Exit would be likely to be more restricted under the counterfactual than under the proposed Arrangement as not only would provisions be put in place to prevent members from resigning to evade obligations under the Rulebook, but it is unlikely that regulations would allow members to leave the Rulebook and join alternative trading arrangements.
- 23.26 In contrast with the most likely form of Government regulation, the proposed Arrangement contemplates the possibility of alternative trading arrangements developing over time. In particular, a member who wishes to continue participating in the industry may resign providing that suitable alternative arrangements are in place in relation to issues such as security and quality (rule 2, section III, Part A). The applicant submits that such a possibility would be unlikely under regulation as the Government has signalled its intention to have one set of rules for all industry players. In this regard, the proposed Arrangement will enhance competition relative to the counterfactual.
- 23.27 The Applicant also submits that the Arrangement does not have the purpose of substantially lessening competition. Since the counterfactual provides for a compulsory market, the purpose of the comprehensive single market relative to the counterfactual cannot be to lessen competition in any market. The purpose of this aspect of the Rulebook is to establish a single market which rationalises the governance arrangements existing in the industry to maximise security and provide efficient governance.
- 23.28 Therefore, the applicant submits that section 27 is not contravened and that this characteristic of the Arrangement is not exclusionary by virtue of section 29(1A).

24. PRICE DETERMINATION PROCESSES

Introduction

- 24.1 The proposed Rulebook establishes processes to determine three types of prices:
- (a) Wholesale electricity prices. The pricing manager calculates the price for electricity in the wholesale market constituted by the Rulebook every trading period (half hour) based on offers submitted by generators and the actual electricity consumed over that period. An equivalent process also applies to establish the price of reserves;
 - (b) Prices for Rulebook services provided to non-members. The rules contained in section IX of Part A provide for the setting of prices for services and benefits supplied by members to non-members that could be provided under the Rulebook; and

- (c) Transmission prices. Section III, Part F creates a process for transmission providers and transmission purchasers to determine a pricing methodology which will be used to establish prices for transmission services.

24.2 These elements might be considered to affect prices in a manner which contravenes sections 27 or 30 of the Act.

Description

Wholesale electricity prices

24.3 The Rulebook establishes a multilateral electricity trading market under which prices are determined by matching offers submitted by generators with the actual quantity of electricity consumed over each half hour trading period.

24.4 The operation of the market under the Rulebook is described at paragraphs 14.38 to 14.47. In summary, for each half hour trading period each generator submits offers to the system operator specifying the quantity of electricity which the generator is willing to sell and the applicable price for that quantity of electricity. Purchasers also submit bids for electricity for each trading period. The system operator's dispatch objective is to maximise for each half hour the gross economic benefits to all purchasers of electricity at the grid exit points, less the cost of supplying the electricity at the grid injection points and the costs of ancillary services purchased by the system operator (rule 2.1, section III, Part G).

24.5 The reconciliation manager determines the amount of electricity traded during each trading period for each generator and purchaser. The pricing manager uses information supplied by the system operator to determine the price for the electricity traded each trading period. Those prices (which will not be identical due to transmission losses from the system between the generator and the purchaser) apply to all generators and purchasers (there may also be some variation due to the difference in price between nodes because of locational factors, including constraints). The rules also reflect the fact that generators may be dispatched by the system operator and will supply electricity in periods where the price is below the price offered by the generator (constrained on). Similarly, the rules also recognise that generators may not be dispatched and may not supply electricity in situations where the price is above the price bid by the generator (constrained off). These market failures are due to transmission constraints, and are reflected in pricing adjustments.

24.6 The clearing manager uses the pricing and reconciliation information to generate invoices which are then issued to purchasers and generators. Instantaneous reserves

are treated similarly, with generators and purchasers submitting bids or offers for reserves when they submit their bids or offers for electricity. The price is determined in the same manner as for electricity.

24.7 Effectively this pricing regime is the same as that applying under NZEM. In Decision 280 the Commission declined the NZEM authorisation application on the grounds that the Commission lacked jurisdiction because the proposed arrangement did not constitute price fixing and did not substantially lessen competition.

24.8 The main rules which implement this process are:

- (a) Section IV, Part G, particularly rule 3, under which the wholesale price of electricity is determined; and
- (b) Rule 6.3, Part H, which provides that the final price for electricity will be calculated in accordance with rule 3 of section IV of Part G, while the final quantity either bought or sold will be determined in accordance with rule 11 of section V of Part G.

Prices for Rulebook services provided to non-members

24.9 Section IX of Part A contains rules which apply where members provide services to non-members that could be provided under the Rulebook. In this situation, the member must supply services to the non-member on the same terms and conditions, except for price, that the services would be supplied under the Rulebook. Under the Rulebook, there is agreement between the members that if any one of them provides any Rulebook services to a non-member, the price for these services will be the price set in accordance with the Rulebook, plus an extra amount to cover additional costs incurred due to the fact that the services are supplied to a non-member (such as costs of enforcement or costs incurred due to the fact that members cannot be certain that the non-member will comply with security obligations and information provisions). If the non-member refuses to pay, the Industry EGB will enforce these provisions by seeking quantum meruit recovery for the services taken by the non-member. As discussed at paragraph 23.14, the purpose of section IX is to remove any incentive for industry players to remain outside the Rulebook.

Transmission prices

24.10 Part F contains rules relating to transmission services. These rules are new and arose both from a desire by industry players to clarify the basis of provision of transmission services and from the GPS. The GPS states that the Industry EGB should ensure that

rules are developed in the area of transmission, including a transmission pricing methodology.

- 24.11 Section III of Part F sets out the process by which transmission providers are to set a pricing methodology for each particular transmission service. This pricing methodology is used to determine the prices for transmission services received by each transmission purchaser. The methodology thereby determined will apply to services currently supplied by Transpower and which are the subject of section I of Part F, as well as changed transmission services supplied by Transpower and any other transmission provider the subject of section II of Part F. Neither the actual price to be charged to each transmission purchaser nor the particular pricing methodology to be used to determine those transmission prices are set by the Rulebook, However, the process for determining and applying an appropriate transmission pricing methodology is provided for.
- 24.12 Under this process, a transmission provider proposes a transmission pricing methodology, and publishes this, along with the design processes and design principles it used in developing that methodology. The transmission provider has to have regard to comments made by transmission purchasers or any other submitter, and may choose to modify the pricing methodology, although it is not bound to do so. This pricing methodology is then submitted to the Industry EGB, which provides comments. The transmission provider may take these comments into consideration and modify the proposed pricing methodology, although there is no requirement on the transmission provider to take into consideration the comments provided by the Industry EGB. The Industry EGB then considers whether to confirm that the pricing methodology is consistent with pricing principles and objectives contained in the Rulebook, which represent the principles and objectives provided for in the GPS. Once a pricing methodology is confirmed, an agreed auditor will determine whether the transmission provider accurately applies that transmission pricing methodology. If the Industry EGB declines to confirm the pricing methodology, the pricing methodology will be referred back to the transmission provider for further consideration. Once the pricing methodology has been confirmed by the Industry EGB and an auditor has approved the application of that methodology by the transmission provider, transmission purchasers are prevented from challenging the validity of that pricing methodology.

Competition analysis

Introduction

- 24.13 It might be argued that one or more of the price determination processes described above:
- (a) has the purpose, effect or likely effect of substantially lessening competition in one or more of the affected markets in breach of section 27; and/or
 - (b) has the purpose, effect or likely effect of fixing, controlling or maintaining (or of providing for the fixing, controlling or maintaining of) the price of services supplied or acquired by the members in competition with each other in breach of section 30.
- 24.14 The remainder of this section discusses the issues which arise.

Wholesale electricity prices

- 24.15 The Applicant submits that, as in NZEM, the provisions which provide for the setting of wholesale electricity prices in the Arrangement do not have the purpose, effect or likely effect of fixing prices in the market for electricity. The Applicant also submits that these provisions of the Arrangement will not lessen competition when compared with the counterfactual. Accordingly, it is submitted that the Commission should decline jurisdiction to consider the authorisation application under both section 30 and section 27 in relation to this aspect of the Arrangement.
- 24.16 Starting with section 30, the Applicant submits that Decision 280, which authorised NZEM pricing, should be applied in this application. In that Decision, the Commission was considering a multilateral trading arrangement with substantially similar pricing characteristics to the proposed wholesale pricing regime under the Arrangement. The Commission canvassed decisions relating to price fixing (such as *Insurance Council of New Zealand (Inc)* (1989) 2 NZBLC (Com) ¶¶ 99-522 and *Radio 2UE Sydney Pty Limited v Stereo FM Pty Limited* (1982) 4 ATPR ¶¶ 40-318) and concluded that price fixing requires some element of certainty as to the level of price. In Decision 280 the Commission cited its own decision in *Insurance Council* (at p104, 482, cited at paragraph 142):

In all of the cases noted above, the terms "fix", "control" and "maintain" are synonymous with an interference with the setting of a price, as opposed to allowing such price to be set in response to changes in the supply and demand for goods and services.

- 24.17 In the NZEM decision, the Commission considered that while the rules constituted a contract, arrangement or understanding, the rules relating to determining the wholesale price did not constitute price fixing because:
- (a) The NZEM rules simply provided for the pricing mechanisms and not the prices, and therefore did not result in the fixing, controlling or maintaining of price;
 - (b) There was no purpose of price fixing as the development of the rules was an open process involving both generators and purchasers and NZEM participants could avoid the NZEM through bilateral contracts; and
 - (c) There was no effect or likely effect of fixing prices. In particular, there was no evidence that the prices established by the mechanisms would diverge significantly from the prices which might be established without the mechanisms and the pricing mechanisms did not allow either generators or purchasers, acting independently or collectively, to predetermine prices. The Commission concluded that there was no element of certainty, continuity or permanence as to price resulting from the pricing mechanism.
- 24.18 The Applicant submits that Decision 280 is correct and applicable to the proposed wholesale pricing regime under the Arrangement. The Applicant submits that the Rulebook does not have the effect of fixing the prices for electricity or reserves because the Arrangement implements a process for determining a market price, rather than implementing a particular price. As the Commission determined in Decision 280, this is likely to track the expected market price which would apply in the absence of the Arrangement over time.
- 24.19 The trading arrangement of the rules also recognises the possibility of continued bilateral financial arrangements. These arrangements may be notified to the clearing manager under rule 7.1 of Part H who will take them into consideration when determining amounts to be paid by particular purchasers and amounts to be paid to particular generators. Furthermore, any generator or purchaser may apply to be exempt from some or all of the trading arrangements where this would result in a net public benefit (rule 3, section I, Part G). This will allow alternatives to bidding, scheduling and dispatch procedures to develop should this be efficient.
- 24.20 In relation to section 27, the Applicant submits that the Crown EGB would be likely to recommend to the Minister that regulations be introduced which effectively replicate the trading arrangements provided for in the Rulebook (including the proposed wholesale pricing regime which is itself based on NZEM) as using a different trading arrangement

would create risk and uncertainty. Therefore, the Applicant submits that the proposed wholesale pricing regime under the Arrangement does not have the purpose, effect or likely effect of substantially lessening competition when compared with the counterfactual.

Prices for Rulebook services provided to non-members

- 24.21 Section IX of Part A contains a set of rules for determining the price which members must charge non-members for services which could be provided under the Rulebook.
- 24.22 The purpose of the rules is to provide incentives to all industry players to become members of the Rulebook. It is intended that as a result of section IX, Rulebook services will not be supplied other than to members (or resigned members who have acceptable alternative arrangements in place). However, the Applicant recognises that despite the purpose of the rules, the rules fixing the price of Rulebook services to non-members will contravene section 30 and therefore be deemed to substantially lessen competition.
- 24.23 In relation to section 27, it is submitted that under regulation there would be no need to address the provision of Rulebook services to non-members since it is apparent from the GPS that compliance with the rules (which will almost certainly include a single pricing mechanism for each service) will be compulsory for all industry players. Consequently, the pricing regime established by Section IX does not, in fact, have the effect or likely effect of substantially lessening competition as compared with the position under regulation.
- 24.24 The Applicant accepts, however, that the Arrangement is deemed by section 30 to have the purpose, effect or likely effect of substantially lessening competition insofar as there is agreement between the members as to the price to be charged to non-members for rulebook services.

Transmission prices

- 24.25 The Applicant submits that the rules included in Part F which provide for the development of a pricing methodology for transmission services do not constitute price fixing and do not have the purpose, effect or likely effect of lessening competition when viewed against the counterfactual.
- 24.26 The pricing methodology provisions provide for a process to be followed in determining a pricing methodology. While the process is a consultative one and the Industry EGB has power to confirm the pricing methodology or decline to confirm the methodology, the

process is not truly a collective process; the transmission provider has discretion to consider or ignore submissions made by industry players or comments of the Industry EGB. The Applicant therefore submits that there is no "contract, arrangement or understanding" in terms of section 30 or section 27. The process involves the transmission provider proposing and ultimately determining a pricing methodology; agreement between competitors in relation to that pricing methodology is not envisaged.

- 24.27 In addition, the particular pricing methodology must be consistent with the pricing principles and objectives in the Rulebook, which have been taken from the GPS. The process is, therefore, likely to be similar to the process contained in the counterfactual, and does not, therefore, result in a substantial lessening of competition.

25. UNIFORM STANDARDS

Introduction

- 25.1 In order to protect the integrity of the national electricity transmission network and the assets connected to it, and to ensure that the electricity available to consumers meets defined quality characteristics, the Rulebook sets standards on grid owners, generators, purchasers and distributors in relation to their equipment and activities. Such standards are essential to maintain frequency and voltage within acceptable operational limits and are referred to as "common quality" standards.
- 25.2 The Rulebook also provides standards for metering, which are necessary to ascertain accurately the amount of electricity each generator supplied and each purchaser took from the grid, for the purposes of reconciliation.
- 25.3 It might, however, be argued that these uniform standards lessen competition in breach of section 27 by requiring industry players to meet a common set of operational requirements in order to participate in the market. This could be seen as restricting competition by reducing the choice of equipment which can be connected to the network and the types of activities which can be undertaken and by creating a barrier to entry for potential entrants who are unwilling or unable to meet such criteria. The Applicant submits that these uniform standards do not have the purpose, effect or likely effect, of lessening competition.
- 25.4 It could also be argued that, in relation to section 29, the uniform standards are provisions of a contract between competitors which have the purpose of restricting the supply of services to competitors or potential competitors who are unwilling or unable to meet such criteria. In relation to this argument, the Applicant submits that the uniform

standards do not have an exclusionary purpose and that, even if they did, they are covered by the section 29(1A) exception as they do not have the purpose, effect or likely effect of lessening competition in any market.

Description

- 25.5 The common quality rules in Part C of the Rulebook were developed under the MACQS process between industry players (see paragraph 3.15).
- 25.6 Achieving a given level of quality requires:
- (a) Performance objectives for the system operator, to ensure electricity is appropriately dispatched and demand and supply are maintained in equilibrium. In furtherance of this, the system operator agrees an annual policy statement with the Industry EGB, which specifies the policy and means by which the system operator intends to achieve the principal performance objectives in the coming year; and
 - (b) Performance obligations for asset owners connected to the grid, including technical standards for generators and lines companies, and obligations on purchasers to contribute to the overall frequency management by limiting the magnitude of any instantaneous changes in offtake of electricity and net rates of change in offtake of electricity to the levels the system operator reasonably requires. These rules are intended to minimise fluctuations in demand that may take supply and demand out of equilibrium and therefore affect frequency.
- 25.7 Generators of all sizes connect to the grid, from one megawatt to one thousand megawatts. Asset owner performance obligations are only imposed on generators who export more than 30MW per station into the grid (the "de minimis" rule (rule 2.5, section III, Part C)). Generating stations that generate less than this are not required to comply with the asset owner performance obligations unless the Industry EGB directs otherwise. (While a 30MW generator may not, on its own, pose much threat to the system, if there are numerous such generators then this might pose a threat to the system if all these small generators were to "trip off" (disconnect from the system) at a particular frequency and the system operator was not prepared for the drop in supply. To compensate for these generators and the frequency range at which they "trip off", the system operator would be required to obtain more reserves which will smooth the frequency if the small generators trip off the system.)
- 25.8 For generating stations that have a net maximum capacity equal to or greater than one megawatt, each grid owner and each distributor must use reasonable endeavours to

provide the system operator with written notice regarding the existence of this generating set, together with such other information as the system operator reasonably requires. This is to ensure that the system operator can plan for contingencies involving these assets and arrange ancillary services to support the system.

- 25.9 The rules also provide for asset owners to procure an equivalence arrangement where it is more cost effective for them to provide an alternative way of achieving a technical standard. The rules also provide for a dispensation to be granted to exempt compliance from a technical standard where the cost consequences of that exemption are met by the applicant. Both arrangements are designed to approximate market mechanisms by providing choices to people about the method in which they will comply with technical standards. Transitional dispensations are also provided for in order to grandfather existing assets which are essential for the efficient operation of the grid but which may not comply with the technical standards in the Rulebook which are designed for new plant.
- 25.10 The metering standards specify who is responsible for meter installations at particular points on the grid, and for the testing and measuring of meters. The market requires accurate measurement of electricity supplied and electricity taken in order to attribute electricity generation and use between the industry players.
- 25.11 The main rules which implement the uniform standards are:
- (a) Rule 2, section II, Part C, which provide for the principal performance objectives of the system operator, which give effect to the common quality standards in the Rulebook. However, rule 4 provides that the system operator may contract for higher levels of common quality;
 - (b) Rule 6, section II, Part C, under which the system operator and the Industry EGB agree the system operator's annual policy statement, giving effect to the common quality standards;
 - (c) Section III, Part C, which sets out the standards imposed on asset owners. There is provision, however, for obtaining a dispensation or having an equivalence arrangement approved;
 - (d) Rule 2.2, section III, Part C, which contains purchaser obligations;
 - (e) Part D, which provides for metering arrangements; and
 - (f) Rule 2, section III, Part I contains provisions in relation to transitional dispensations.

Competition analysis

Introduction

- 25.12 It might be argued that the uniform standards lessen competition in breach of section 27 by requiring industry players to meet a common set of operational requirements in order to participate in the market. This could be seen as restricting competition by reducing the choice of equipment which can be connected to the network and the types of activities which can be undertaken, and by creating a barrier to entry for potential entrants who are unwilling or unable to meet such criteria.
- 25.13 In response to this argument, the Applicant submits that the uniform standards do not have the purpose, effect or likely effect of substantially lessening competition in any market. These standards are required to deliver a consistent quality of supply. In addition, the metering standards are necessary for the efficient operation of the market; it is difficult to run a credible market when industry players are unable to determine the quantities of electricity bought and sold.
- 25.14 It could also be argued that, in relation to section 29, the uniform standards are provisions of a contract between competitors which have the purpose of restricting the supply of services to competitors or potential competitors who are unwilling or unable to meet such criteria. In relation to this argument, the Applicant submits that the uniform standards do not have an exclusionary purpose and that, even if they did, they would be covered by the section 29(1A) exception as they do not have the purpose, effect or likely effect of substantially lessening competition in any market.
- 25.15 Each section is now addressed in turn.

Section 27

- 25.16 The starting point for the section 27 analysis is to compare the proposed uniform standards in the Rulebook against the counterfactual. The Applicant submits that the asset owner performance obligations and purchaser obligations in the regulatory counterfactual are likely to be identical to those applying under the Arrangement because:
- (a) The common quality standards have been developed in accordance with the authorised MACQS process and have been negotiated between industry players;
 - (b) These rules represent operative provisions for maintaining the quality of electricity traded in the market; and

- (c) The Crown EGB is likely to adopt these rules in regulations recommended to the Minister because they are established and do not require the Crown EGB to immediately become involved in developing technical rules in an area in which it may not have expertise or experience.
- 25.17 The Applicant submits that the regulatory counterfactual would include the same common quality standards as the proposed Rulebook. The Applicant also submits that the regulatory counterfactual would include provisions similar, if not identical, to the metering arrangements provided for in the Rulebook, because these arrangements are currently part of MARIA and are therefore proven to work. It would also be unnecessarily complex and inefficient to require industry players to shift to a different metering arrangement.
- 25.18 Accordingly, it is submitted that in comparison with the counterfactual, the uniform standards contained in the Rulebook in relation to common quality and metering do not have the purpose, effect or likely effect of lessening competition.
- 25.19 It is further noted that:
- (a) The purpose of the common quality standards is to provide an efficient means of delivering electricity where market mechanisms to determine those standards are not yet technically and commercially feasible. The standards also provide certainty for long term investment, thereby enhancing competitive outcomes;
- (b) The common quality standards are intended to maintain the integrity of the system and prevent failure which occurs when supply and demand are not in equilibrium. The purpose of the metering arrangements is to provide for the efficient operation of the market. The industry has agreed to be bound by these uniform standards because they are essential to the operation of the market. The purpose is not to lessen competition, but to enable the market to operate; and
- (c) The asset owner performance obligations allow generator entrants to safely connect to the grid and supply electricity, knowing that in the normal course they will be able to remain connected to the grid and continue supplying electricity. The asset owner performance obligations, together with the purchaser obligations and system operator principal performance objectives provide certainty, which will encourage entry to the market.

Section 29

- 25.20 The Applicant submits that the uniform standards are not exclusionary practices under section 29. In particular, these provisions do not have the purpose of restricting the supply of services to parties, but instead have the purpose of maintaining the integrity and efficiency of the system. The common quality arrangements also have the purpose of preventing failure which would otherwise occur when supply and demand are not in equilibrium.
- 25.21 In the alternative, the Applicant submits that should the Commission find that section 29(1) does apply, then the exception contained in section 29(1A) is applicable as the uniform standards do not have the purpose, effect or likely effect of lessening competition in any market when compared with the counterfactual, for the reasons given above.
- 25.22 In fact, the uniform standards have the purpose and effect of encouraging entry, and thereby competition since entrants know that they are participating in a secure system, and that there are standards in place to protect the integrity and efficiency of the system. Potential entrants are assured that the assets of other industry players will not adversely affect the grid or individual assets.

26. PERFORMANCE ASSURANCES

Introduction

- 26.1 To ensure that the members meet their performance and payment obligations in relation to electricity trading under the Rulebook, the proposed Arrangement provides that:
- (a) to become a member, an applicant must satisfy the Industry EGB that it is likely to be able to carry out its responsibilities as a member; and
 - (b) members must satisfy ongoing prudential requirements.
- 26.2 Although these rules are intended to ensure the smooth operation of the system and minimise the financial risks of trading on the market, it could be argued that the rules may potentially act as barriers to entry by discouraging new entrants who are unable or unwilling to comply. This could be seen as substantially lessening competition under section 27 or as a contract between competitors which contains provisions which have the purpose of restricting the supply of services to competitors or potential competitors in breach of section 29.

- 26.3 In this section, the Applicant submits that the performance assurances:
- (a) in relation to section 27, do not have the purpose, effect or likely effect of substantially lessening competition in any market; and
 - (b) in relation to section 29, do not have an exclusionary purpose and that, even if they did, they are covered by the section 29(1A) exception as they do not have the purpose, effect or likely effect of substantially lessening competition in any market.

Description

Introduction

- 26.4 The purpose of the performance assurances is to ensure that the various performance and payment obligations under the Rulebook are properly carried out. Although having confidence in counterparties is important in any commercial setting, it is especially important in the electricity industry for the following reasons:
- (a) The interconnectedness of the market creates a "systemic risk" whereby the failure of one member may have repercussions for many others members;
 - (b) The wholesale electricity trading market is "blind" in the sense that a particular generator does not know the identity of the purchaser or purchasers of the particular electricity it has supplied to the national pool. Despite not knowing the purchasers' identities, generators are able to rely on purchasers being financially sound as a result of the entry criteria and prudential obligations to which members are subject; and
 - (c) In an overall sense, the social and commercial dependence of the country on the reliable supply of electricity justify the performance assurances contained in the Rulebook.

- 26.5 The main performance assurances contained in the Rulebook are the restrictions on becoming a member and the ongoing prudential requirements.

Entry criteria

- 26.6 In order to qualify for entry as a member of the Rulebook, an applicant must satisfy the Industry EGB that it is likely to be able to carry out its responsibilities as a member of the class in which the application is made, i.e. generator, purchaser, grid owner, distributor, direct consumer or voting customer. Applicants for entry as a member are also required

to provide to the Industry EGB a written application and such other information as the Industry EGB may require. The purpose of these provisions is to ensure that members are technically and financially capable of carrying out their obligations under the Rulebook.

Prudential requirements

- 26.7 The prudential provisions specify an ongoing level of security that specific classes of members (that is, generators, purchasers, distributors, grid owners, and direct consumers) must maintain. The purpose of these requirements is to ensure that the members can meet their financial obligations under the rules. For purchasers, distributors, or grid owners, the prudential requirements are calculated according to a formula based on the cost of energy purchases. Generators may be required to give security in relation to ancillary services purchases, to ensure that they are able to fulfil their obligations in relation to payment for ancillary services.
- 26.8 Where purchasers, distributors, grid owners, direct consumers or generators are required to satisfy prudential requirements, they have a choice as to the form of prudential security given. In some cases an acceptable credit rating is sufficient, but in other cases a cash deposit may be made, or the member may provide a guarantee or letter of credit, provide a bond, obtain a third party guarantee or lodge a hedge settlement agreement.

Implementation

- 26.9 The main rules which implement the performance assurances described above include:
- (a) Rule 1.1, section III, Part A, which requires applicants for entry to provide the Industry EGB with a written application and to provide the Industry EGB with any information required;
 - (b) Rules 1.3 and 1.4 section III, Part A, which requires applicants for entry to satisfy the Industry EGB that it will likely be able to carry out its responsibilities as a member of the class in which the application is made;
 - (c) Rule 2, Part H, which specifies the requirement for prudential security and provides for the calculation of the level of that security; and
 - (d) Rule 5, Part H, which enables the clearing manager to require additional security for a particular current billing period. This is not a review of the base level of security, but applies for a temporary period.

Competition analysis

Introduction

- 26.10 It could be perceived that the performance assurances contravene sections 27 and 29 of the Act. In particular, it might be thought that:
- (a) In relation to section 27, competition could be substantially lessened by restricting the ability of potential entrants to join the Rulebook; and
 - (b) In relation to section 29, the Rulebook is a contract between competitors which contains provisions which have the purpose of restricting the supply of services to competitors or potential competitors.
- 26.11 The Applicant submits that the performance assurances do not have the purpose, effect or likely effect of substantially lessening competition in any market or an exclusionary purpose and accordingly sections 27 and 29 do not apply.

Section 27

- 26.12 It could be argued that the performance assurances contained in the Rulebook may potentially act as barriers to entry by discouraging new entrants who are unable or unwilling to comply with the entry criteria and the ongoing prudential requirements.
- 26.13 The Applicant submits that the performance assurances do not have the purpose, effect or likely effect of substantially lessening competition in any market.
- 26.14 The starting point is to compare the proposed performance assurances in the Rulebook against the counterfactual.
- 26.15 The Applicant submits that regulations imposed under the counterfactual are likely to include prudential requirements, since prudential requirements are necessary for the efficient operation of the market and minimise the potential for any residual liability falling on the Crown EGB or the Government. In particular, comparing the regulatory counterfactual with the proposed Arrangement:
- (a) Entry criteria will be equally important for minimising the risk of a member failing or not complying with the rules which could ultimately affect the security of supply of electricity; and
 - (b) Ongoing prudential requirements will also be important for minimising the systemic risk of a cascade of failures and for giving industry players and entrants the confidence to operate in a blind market.

- 26.16 Since the performance assurances in the Rulebook all relate directly to the actual performance obligations of a party under the rules and because they have been agreed by the industry based on the collective experiences of industry players, there is no reason to expect that the Government would adopt less strenuous performance assurances under regulation than those contained in the Rulebook.
- 26.17 The Applicant submits that the performance assurances are actually a prerequisite to competition and have the purpose of *encouraging* entry and competition. The provisions encourage entry by giving members a high degree of confidence as to payment and minimising the trading risks in relation to the sale and purchase of electricity on a blind market. This encourages members, especially generators, to enter the market.
- 26.18 Relative to the counterfactual, the Applicant submits that the performance assurances do not have the purpose, effect or likely effect of substantially lessening competition in any market.
- 26.19 The performance assurances in the present Rulebook are similar to those provided for in NZEM. The prudential requirements in NZEM were considered by the Commission in Decision 280 where the Commission commented (paragraph 191):

The Commission agrees that electricity has special characteristics which give suppliers limited recourse to remedies in the case of non-payment. First, once electricity has been supplied, it is not possible for the seller to recover it. Second, in many instances, there would be serious social and political implications if a seller ceased supply (and the lights went off) in response to non-payment by a buyer.

- 26.20 The Applicant submits, as was found by the Commission in Decision 280, that the entry and prudential requirements, and the levels of security imposed by the prudential provisions are not such as to deter potential entrants to the extent that the wholesale market would be less competitive.

Section 29

- 26.21 The Applicant submits that the prudential requirements and other performance assurances are not exclusionary practices under section 29. In particular, these provisions do not have the purpose of restricting the supply of services to parties, but instead have the purpose of ensuring the smooth operation of the system and minimising risk for market players. Both of these features will actually encourage entry.
- 26.22 In relation to the NZEM prudential requirements, the Commission stated in Decision 280 that (paragraph 210):

The purpose of the prudential provisions, as stated in the application, is to protect the integrity of the "blind" market, where buyers and sellers do not know the identities of counterparties. The Commission is of the view that no purpose of excluding new entry into the generation market can be inferred from the material before the Commission. As the Commission noted in the draft determination, the prudential provisions limit the amount of risk a new generator would have to bear. This appears to be a more significant factor than the cost of the prudential provisions to a new generator.

- 26.23 It is submitted that the same conclusion is appropriate here.
- 26.24 In the alternative, the Applicant submits that should the Commission find that section 29(1) does apply, then the exception contained in section 29(1A) is applicable as the performance assurances do not have the purpose, effect or likely effect of substantially lessening competition in any market for the reasons given above.

27. TRANSMISSION SERVICE DEFINITION AND TRANSMISSION INVESTMENT

Introduction

- 27.1 Transport refers to the provision of transmission services across the national grid. The rules relating to transport are new. As discussed above (see paragraph 14.30), the provision of transmission services has historically been hampered by the lack of clarity surrounding the definition of these services, an unwillingness for industry players to commit to and pay for investments which benefit a wide group of transmission service users and the risk surrounding investment (see paragraph 14.33).
- 27.2 The rules contained in Part F are intended to clarify the definition of the transmission services that are provided by transmission providers and to encourage efficient investment. The rules are the result of a desire by the industry to clarify the provision of transmission services. The GPS also envisaged the creation of rules providing for transmission (Attachment 1, GPS, Folder of Supporting Material, number 7, see paragraph 27.14).
- 27.3 The processes set out in Part F for determining services and investment may potentially be considered to have the purpose, effect or likely effect of substantially lessening competition in contravention of section 27 of the Act. Entry may also be discouraged because the processes for deciding matters such as investment and service changes could result in an entrant being obliged to take and pay for new or changed transmission services that they do not favour.

- 27.4 The Applicant submits that these processes do not have the purpose, effect, or likely effect of substantially lessening competition in the market for transmission services or any other relevant market.

Description

- 27.5 There are three aspects of the transport rules that the Applicant seeks authorisation for within this characteristic (the process for developing a pricing methodology has been considered previously (see section 24):

- (a) The collective decision making process provided for by the Arrangement in relation to the determination of the set of transmission service definitions and service measures from which Transpower and a Transpower customer determine the service definitions and service measures applying to the transmission services supplied by Transpower to that Transpower customer;
- (b) The process by which Transpower determines transmission investment and the protection the Arrangement affords Transpower's pricing in relation to this investment for the transmission services provided by that new asset fall; and
- (c) The provisions for determining and applying new or changed transmission services. If a service change proposal (being those transmission purchasers which the transmission provider believes would receive the new or changed service) is approved, then all transmission purchasers eligible to vote on that proposal are obliged to take and pay for the new or changed service, even if the particular transmission purchaser voted against the proposal.

Determining the set of service definitions and service measures

- 27.6 Section I of Part F sets out the process undertaken by Transpower and Transpower customers in determining a common set of service definitions and service measures from which Transpower and each customer choose applicable service definitions and service measures for transmission services supplied by Transpower to that Transpower customer. Transpower will propose service definitions and service measures for the transmission services it provides to its customers. People may then make submissions on these proposed definitions and measures.
- 27.7 The Industry EGB will refer these definitions and measures to a working group consisting of Transpower representatives and Transpower customer representatives (Transpower representatives have 50% of the total votes, and Transpower customer representatives have 50% of the votes). The working group then recommends a set of

service definitions and service measures, which Transpower and Transpower customers vote on. If they are unable to agree, the whole process is repeated a second time. If they are still unable to agree, the set of service definitions and service measures is referred to arbitration. The arbitral tribunal will make a decision on the set of service definitions and service measures from which Transpower and Transpower customers choose applicable service definitions and service measures applying to the transmission services supplied by Transpower to that customer.

Transmission investment

- 27.8 Rule 6, section I, Part F provides that Transpower will prepare a service delivery plan, which may include a statement of investment opportunities. The purpose of the statement of investment opportunities is to provide Transpower customers with an opportunity to comment on the proposed investments, the intention being that sometimes customers may be able to provide more efficient alternatives to the investment proposed by Transpower. However, Transpower is not obliged to give effect to any comments made on the statement of investment proposals by Transpower customers.
- 27.9 If Transpower identifies investments to be made in this statement of investment opportunities, and the investment is subsequently undertaken, Transpower's transmission pricing in relation to the service from this new asset is protected for a five year period. If Transpower commits irrevocably to expenditure identified in the statement of investment opportunities, the value of the asset for the purposes of determining transmission prices will not be reduced for five years, even if demand for the service provided by the asset reduces.

Service changes

- 27.10 When a service change proposal is approved by a resolution, all transmission purchasers eligible to vote on a transmission service change proposal are bound to pay for that new or changed service, even if they voted against such proposal (rule 3.12, section II, Part F). Transmission providers may propose a service change, including new services. In proposing such a change, the transmission provider must notify transmission purchasers of the confirmed pricing methodology for the transmission service resulting from the service change. The transmission purchaser then notifies the Industry EGB of the identities of transmission purchasers eligible to vote on the service change proposal. Transmission purchasers are eligible to vote on a service change proposal if the transmission provider determines that they would receive the new or changed service. Votes are allocated on the basis of the amounts the transmission

purchasers could reasonably be expected to pay under the confirmed pricing methodology in the next 12 months for the new or changed transmission service. There is provision for appealing service change proposals or voting allocations to the Rulings Panel.

- 27.11 Transmission purchasers eligible to vote will then vote on the service change proposal. If at least 75% of the votes cast are in favour of the service change proposal then the service change will apply to all transmission purchasers who have a contract with the transmission provider for the provision of the applicable service, and all transmission purchasers who do not have a contract with the transmission provider where the service change is intended to create a contract for the provision of that service. This means that all transmission purchasers who are eligible to vote on the service change proposal are obliged to take and pay for that new or changed transmission service. The process is effectively a collective decision making process where purchasers collectively decide whether or not to acquire a service.

Competition analysis

Determining the set of service definitions and service measures

- 27.12 It might be argued that the provisions relating to determining the set of transmission service definitions and service measures contravene section 27 of the Act, because they have the purpose, effect, or likely effect of substantially lessening competition by reducing individual freedom of choice. This is a collective process undertaken by Transpower customers in conjunction with Transpower. The set of service definitions and service measures subsequently determined might be seen to substantially lessen competition by limiting the available service definitions and service measures that Transpower and Transpower customers can choose.
- 27.13 The Applicant submits that the rules relating to transmission service definitions and service measures do not have the purpose, effect or likely effect of substantially lessening competition when compared with the counterfactual for the following reasons:
- (a) The set of service definitions and service measures from which to choose is expected to provide a comprehensive range of service definitions and measures and therefore this set will not restrict choice in any way;
 - (b) The actual applicable service definitions and measures applying to transmission services supplied by Transpower to a particular customer are not agreed collectively, but are determined individually between Transpower and that customer, and therefore do not affect competition; and

- (c) If transmission investment decisions become politicised, a Crown EGB would face considerable pressure to take a more "hands-on" approach to transmission investment. This suggests that a Crown EGB would focus less on defining service outputs and more directly on securing the investment inputs to keep risk at "acceptable levels". Definition of service outputs is critical for effective competition at the margin where transmission expansions are being considered, since ill-defined service measures make it difficult to compare the relative cost of alternative solutions. Therefore, the counterfactual would be less effective than the proposed arrangement in encouraging substitute providers such as generators and demand-side management.

27.14 The Applicant therefore submits that the provisions do not have the effect or likely effect of substantially lessening competition. In addition, the Applicant submits that the rules do not have the purpose of substantially lessening competition. The purpose of the provisions is to provide clarity around transmission services, which will have the effect of encouraging competition because entrants and current industry players will know that there is more certainty as to service and pricing.

Transmission investment

27.15 It may be considered that the provisions relating to transmission investment have the purpose, effect or likely effect of substantially lessening competition because of the nature of the decision making and the requirement to continue providing Transpower with a return on the new asset even if demand drops. The Applicant submits that there is no substantial lessening of competition in comparison with the counterfactual, because:

- (a) The current provisions represent nearly one year of negotiation between Transpower and transmission purchasers, and are intended to function efficiently; it is more efficient for the Crown EGB to recommend the inclusion of the Part F provisions in the regulatory counterfactual rather than spend time and money developing alternative rules; and
- (b) The GPS requires rules (or regulations) to provide for transmission services, and specifically system expansion and replacement, including a statement of investment opportunities to be produced by Transpower. The GPS provided that (Attachment 1, GPS, Folder of Supporting Material, number 7):

14 The Government expects transmission services to be priced efficiently, and to this end:

...

- the pricing of new and replacement investments in the grid should provide grid users with strong incentives to identify least cost investment options, including energy efficiency and demand management options;

...

16 To assist in the application of this principle, Transpower should produce annually a rolling five-year Statement of Investment Opportunities in relation to forecasts of medium term system adequacy. The Statement of Investment Opportunities will assist grid users to identify opportunities for generation (including distributed generation) and demand-side management (including energy efficiency and load management), and to determine whether these are more appropriate than further investment in the grid by Transpower.

...

18 Where the Governance Board concludes that investment by Transpower is necessary, the cost of that investment should be recoverable by Transpower in accordance with the pricing methodology determined by Transpower and agreed with the Governance Board.

...

23 Transpower will be responsible for developing the transmission pricing methodology consistent with the objectives and principles for the provision of transmission services outlined in Attachment 1. The Governance Board should ensure that consistency with the objectives and principles have been achieved. The Governance Board is also to ensure that transmission charges established consistent with the transmission pricing methodology are enforceable on the same basis as other rules set by the Governance Board.

27.16 When compared with this counterfactual, the investment provisions do not substantially lessen competition; they are effectively neutral. On this basis, the Applicant submits that the investment provisions have neither the purpose, effect or likely effect of substantially lessening competition.

27.17 In addition, the Applicant submits that the purpose of the investment provisions is to ensure that Transpower invests efficiently in new assets, when investing might otherwise be risky if Transpower were not assured of a return on those assets. Historically, there has been under-investment in transmission assets because it is commercially risky to invest in expensive assets without a guaranteed return on those assets.

Service changes

- 27.18 It may be argued that the provisions relating to service changes have the purpose, effect or likely effect of substantially lessening competition because they force people to take services which they might otherwise have chosen not to take. However, the Applicant submits that in comparison with the counterfactual, the rules do not have the effect or likely effect of substantially lessening competition because it is likely that similar rules will be included in the regulatory counterfactual, given the Government's desire to provide more certainty around transmission services and investment. These rules represent agreement between the major players in the transmission market, and are therefore a logical choice for the Crown EGB when determining proposed regulations.
- 27.19 Therefore, in comparison with the counterfactual, the Applicant submits that the Part F provisions relating to implementing new or changed transmission services do not have the purpose, effect or likely effect of substantially lessening competition.
- 27.20 The purpose of this collective decision-making process is to eliminate the incentives for free-riding that might otherwise exist. Transmission purchasers could vote against a service change proposal, in the belief that others will vote for the service change and will then pay for such change. A transmission purchaser could therefore avoid paying for the service (if payment was imposed on those who had elected to receive the service) but still take advantage of such service. By requiring all eligible voters to take and pay for the service if approved by a resolution, the rules eliminate the incentive on some transmission purchasers to free-ride on the decision by other transmission purchasers to take and pay for the service. Therefore, this characteristic of the Arrangement does not have the purpose, effect or likely effect of substantially lessening competition in any of the relevant markets.

28. COST ALLOCATION

Introduction

- 28.1 The operation of the Rulebook creates costs which are allocated among the members. The basic principle for the allocation of these costs is "user pays". For example, the costs of each particular Part of the Rulebook are allocated to the members of that Part. In this way, the members who benefit from particular services pay for those services. There are also common costs to be divided amongst members, such as the costs of governance, the system operator, and service providers.

- 28.2 The method by which these costs are allocated might be considered to affect prices in a manner which contravene sections 30 of the Act on the basis that the provisions in the Rulebook relating to cost allocation have the effect of fixing, controlling or maintaining prices for services acquired by parties to the contract. If section 30 is contravened, the provisions are deemed to have the purpose, effect or likely effect of substantially lessening competition in breach of section 27.
- 28.3 The Applicant submits that the cost allocation provisions do not constitute price fixing because:
- (a) For common services that are acquired, there is no competition for these services. The services are not supplied to parties in competition with each other. The services, such as governance, are provided to the industry as a whole, and therefore the parties are not in competition for these services;
 - (b) The division of such costs will not necessarily affect the *prices* of any goods or services created as a result; and
 - (c) These services could be considered to be acquired jointly, and therefore fall within the exception to section 30 contained in section 33.
- 28.4 It could also be argued that these provisions are a direct breach of section 27. This is denied by the Applicant for the reasons outlined below.

Description

- 28.5 There are a number of types of costs allocated under the Rulebook.
- 28.6 The costs of conducting each section of the Rulebook, including the costs of governance (which includes fees for the Industry EGB), are allocated according to the membership of each part.
- 28.7 The service provider services are all acquired jointly by the members of the Rulebook. These services are services needed by the members to ensure the system operates, such as the system operator, reconciliation manager, pricing manager, clearing manager and registry. These costs are allocated amongst members of the particular Parts of the Rulebook who use these services. For example, the costs of the registry are allocated to purchasers on the basis of the number of ICPs, which is the same basis as the calculation of votes to members of Part E; the costs of the pricing manager and reconciliation manager (with the exception of grid injection and grid exit point fees) are allocated under Part G according to volume (MWh), which is the same basis as for allocation of votes to each member of Part G.

28.8 Costs of ancillary services which relate to MACQS determined common quality standards are also allocated under the Rulebook on a similar basis to people who benefit from that service. It is helpful to consider the individual ancillary services:

- (a) Instantaneous reserve charges are divided between availability and event charges. Availability costs are allocated to generators and the HVDC owner, as the instantaneous reserves are available for the use of these people. Event charges (in the event that instantaneous reserves are used) are allocated to the event causers. Any event charges paid for an event are rebated to availability cost payees;
- (b) Voltage support costs are allocated amongst distributors and generators in each zone;
- (c) Frequency keeping costs are allocated to retailers;
- (d) Black start costs are allocated to the grid owner; and
- (e) Over-frequency reserve costs are allocated to the HVDC owner.

28.9 In addition, there are one-off expenditures that are also allocated by the Rulebook:

- (a) The NZEM reform costs, which are allocated to persons to the extent that they would have been allocated if NZEM rules had not been terminated;
- (b) MARIA costs, for which MARIA members remain liable to the extent they would have been liable had MARIA not terminated;
- (c) MACQS recovery costs, which will be recovered by the clearing manager in monthly instalments over a five year period from generators, purchasers, grid owners and distributors;
- (d) Switching and registry development costs, which have been paid by select "principals" of the industry. These costs are paid over 36 equal monthly instalments through the clearing manager, on the basis of a fee charged to users of the switching system. These costs are paid directly to the principals. The use of the switching system is conditional on the payment of the fee; and
- (e) In relation to development costs of the Rulebook, these costs are shared between NZEM members, MARIA members, Transpower, and the Grid Security Committee (which is funded by Transpower and recovered from the members of Part C under section III, Part I). The share of the development

costs of the Rulebook borne by NZEM, MARIA, and Transpower are dealt with outside the Rulebook.

- 28.10 In general these costs are allocated to users of the services, although the Rulebook specifies a basis on which each member's portion of the costs are calculated.

Implementation

- 28.11 The main relevant rules which implement the cost allocation methodologies described above are:

- (a) Rule 3, section I, Part A, allocating the costs of Part A, including the service provider and administration costs attributable to Part A. Costs are allocated amongst the members of Part A on a pro rata basis. Every person who is a member of any other Part is also a member of Part A;
- (b) Rule 1.20, section II, Part A, which allocates the costs of indemnities of the Industry EGB and the directors of the Industry EGB amongst the members of Part A, which are all the members of the Rulebook;
- (c) Rule 1.24, section II, Part A, which allocates the costs of the Industry EGB and the Rulings Panel amongst the members of Part A;
- (d) Schedule A7 which sets out the fees payable by members;
- (e) Rule 3, section I, Part C, which allocates the service provider costs of Part C amongst the members of Part C, which are generators, purchasers, grid owners, distributors, and voting customers;
- (f) Rule 6, section IV, Part C, which allocates the costs of ancillary services;
- (g) Rule 3, section II and section III, Part D, which allocates the service provider costs of the respective sections of Part D amongst the members of section II, generators, grid owners and retailers;
- (h) Rule 1.4, Part E, which allocates the service provider costs (registry costs) of Part E amongst members of Part E, which are retailers and distributors;
- (i) Rule 1.6, Part F, which allocates the fees attributable to Part F amongst transmission purchasers (including Transpower customers) and transmission providers (including Transpower);

- (j) Rule 5, section I, Part G, which allocates the costs of service providers of Part G (such as the system operator, reconciliation manager, and pricing manager) amongst the members of Part G, who are purchasers and generators;
- (k) Rule 1.3 of Part H, which allocates the costs of service providers of Part H (such as the clearing manager) amongst the members of Part H, who are generators, purchasers and any other members to whom the costs of ancillary services are allocated;
- (l) Rule 13 of Part H, which provides for the invoicing and payment of fees allocated to individual members of the Rulebook, such as NZEM reform costs, auction fees, administration costs, service provider fees, customer switching development fees, MACQS development costs, and profiling fees of the reconciliation manager. These fees are allocated under Schedule A7. This rule also imposes costs on members such as membership fees, and fixed fees for each grid exit point and grid injection point;
- (m) Rule 4, section IV, Part I, which provides for MARIA cost recovery amongst the relevant parties who had been liable for such costs under the previous arrangements;
- (n) Rule 4, section V, Part I, which provides for NZEM cost recovery amongst NZEM market participants; and
- (o) Rules 1 and 2, section III, Part I, which provides for the recovery of MACQS development costs, including EGEN development costs paid by the Grid Security Committee, and transitional dispensation costs.

Competition analysis

Introduction

28.12 It might be argued that one or more of the cost allocation methodologies described above:

- (a) has the purpose, effect or likely effect of substantially lessening competition in the affected markets in breach of section 27; and/or
- (b) has the purpose, effect or likely effect of fixing, controlling or maintaining (or of providing for the fixing, controlling or maintaining of) the price of electricity supplied or acquired by the members in competition with each other in breach of section 30.

28.13 The remainder of this section discusses the issues which arise.

Section 27

28.14 It is likely that the allocation of most of these costs will remain identical under the counterfactual, which is Government regulation through the Crown EGB. The Crown EGB will likely allocate costs in a similar way to that described above for each section, as this is a fair, efficient way of allocating costs. It means that people who receive the services pay for those services. Therefore, there is no difference in the competitive effect of the counterfactual and the Arrangement, and thus no purpose, effect or likely effect of lessening of competition.

28.15 Furthermore:

- (a) some method of cost allocation is necessary for the Arrangement and resulting market to be created at all;
- (b) the allocation of *costs* will not have any direct effect on any final *prices*; and
- (c) the purpose of cost allocation provisions is simply to fairly and efficiently allocate the costs of the Arrangement between the participants.

Section 30

28.16 The issue of when a cost allocation methodology may contravene section 30 was discussed in the MACQS authorisation (Decision 369, 13 August 1999). In looking at cost allocation methodologies agreed between competitors, the Commission drew a distinction (paragraphs 68 to 75) between:

- (a) the allocation of common facility costs which will not necessarily impact on final prices (as in, for example, the NAD decision) to which section 30 does not apply; and
- (b) the allocation of costs of a service which the parties acquire in competition with one another and where those costs will necessarily impact directly on final prices to which section 30 does apply.

28.17 The Commission went on to hold that the method of allocating common quality costs under MACQS fell within the second category.

28.18 The Applicant agrees with the distinction drawn by the Commission in the MACQS authorisation between complying and infringing cost allocation methodologies. However, the Applicant submits that the Commission should take this opportunity to

revisit its classification of the allocation of common quality costs as falling into the latter category.

28.19 Before discussing common quality costs, the Applicant submits that all the other cost allocation methodologies comply with section 30 in the sense that they involve, like NAD, the allocation of common facility costs and will not directly impact on final prices. Therefore, it is submitted that section 30 does not apply to any of the cost allocation mechanisms referred to in paragraphs 28.6, 28.7 and 28.9.

28.20 In relation to common quality costs described in paragraph 28.8, the Applicant submits that the method for allocating common quality costs between members does not contravene section 30 and invites the Commission to distinguish or reconsider this part of the MACQS decision. In particular, the Applicant submits that:

(a) The members do not compete with one another for the acquisition of common quality related services. Rather, the system operator has contractual obligations on behalf of all members to ensure that common quality standards are met pursuant to the system operator's Principle Performance Obligations. To meet these obligations, the system operator contracts for common quality related services as required. The system operator is therefore the sole procurer of such services for the industry. Therefore, even though the costs are allocated according to how they were created, there is no competitive acquisition of these services; and

(b) The common quality costs attributed to each member do not have any necessary impact on wholesale or retail electricity prices. First, like any other component cost, there is no certainty that they will directly impact on the final market price. Second, the ancillary service costs are inconsequential compared with the value of electricity purchased through the wholesale market. For example, between 1 July 2000 and 30 June 2001 the cost of ancillary services was \$29m compared with \$1,934m paid by purchasers on NZEM.

28.21 For these reasons, the Applicant submits that this characteristic of the Arrangement does not constitute price fixing in terms of section 30 of the Act.

28.22 In the alternative, if the Commission finds that section 30 does apply, the Applicant submits that the allocation of common quality costs is covered by the joint buying exception in section 33 of the Act as the members are acting collectively (through the system operator) in acquiring the common elements of quality.

29. INFORMATION DISCLOSURE REQUIREMENTS

Introduction

- 29.1 The proposed Rulebook implements a regime of information disclosure which is designed to aid in the transparency of decision making by industry players and, in particular, generators, purchasers and service providers.
- 29.2 The Applicant recognises that some might consider that these provisions have the purpose, effect or likely effect of substantially lessening competition because they provide for the sharing of information between competitors. The Applicant submits that these rules do not substantially lessen competition because no sensitive pricing information is provided. If anything, the sharing of information encourages competition because with more information available better decisions can be made.

Description

- 29.3 The Rulebook broadly requires disclosure of information by participants in two circumstances (section VII, Part A):
- (a) Except where a participant is requested, and agrees, to treat information in confidence or the participant is required by the rules, a regulatory authority, or by law to keep the information confidential, every participant under the rules must make available to every other participant upon request all information provided to it by any other participant; and
 - (b) Except where a participant is legally obliged to treat the information in confidence or the release of the information is prohibited by law, every generator, purchaser and service provider must publish "relevant information" at the earliest practicable opportunity:
 - (i) once disclosure of the information would not, or would cease to, commercially disadvantage it; or
 - (ii) after the information is disclosed to any other person not obliged to treat the information in confidence.

The term "relevant information" is widely defined and includes any information generated or held at any time by a generator, purchaser or service provider about itself (including its electricity activities, plant, assets, generation capacity, electricity demand, contracts or financial position) which:

- (i) if disclosed, would be likely to materially affect the price of electricity or of any contracts relating to electricity traded under the rules; and
- (ii) not reasonably available to other generators and purchasers which actively trade in a form substantially as useable as the form in which it is available to that generator or purchaser.

29.4 However, bid and offer information must be kept confidential except to the extent that the Industry EGB directs the disclosure of historic bid and offer information (which it can only do where it is satisfied that such disclosure will not result in any breach of the Act or any other legislative or regulatory restriction).

Competition analysis

29.5 It might be argued that the rules may result in a greater degree of information disclosure than that which might usually be expected to occur where commercial parties are acting competitively and that the information disclosure regime provided by the rules is therefore likely to substantially lessen competition in a market.

29.6 The Applicant submits that these information disclosure rules do not substantially lessen competition because:

- (a) prospective bid and offer information and, except to the extent that the Industry EGB otherwise directs, historic bid and offer information is to be treated as confidential. This significantly reduces the risk of any price signalling behaviour on the part of participants resulting from the information disclosure regime contained in the rules.
- (b) a generator, purchaser or service provider is not obliged to disclose "relevant information" where to do so would commercially disadvantage it (except where it has already been disclosed to a party which is not bound by a confidentiality obligation). This is a very broad exception to disclosure and can be expected to be relied upon by such organisations to avoid disclosure of any competitively sensitive information; and
- (c) the Government, in the GPS, has signalled that it is looking for a greater degree of information disclosure including the public release after three months of information concerning offers by generators for dispatch (including ancillary services). This is reinforced by the ability for regulation to be made pursuant to the Electricity Act 1992 (as amended by the Electricity Amendment Act 2001) requiring information disclosure. Consequently, the degree of information

disclosure currently proposed in the rules (which has been included at the insistence of smaller industry players and consumer interests) is likely to be reflected in any regulatory regime introduced by the Government. Hence, the information disclosure regime is unlikely to substantially lessen competition when compared with the regulatory counterfactual.

- 29.7 Moreover, disclosing the information required under the information disclosure regime is not likely to result in price signalling or collusive behaviour by market participants. If anything, the Applicant submits that the disclosure of this information is likely to enhance the efficient operation of the relevant markets because the more information industry players have the more likely it is that they will make efficient decisions.

30. SUMMARY

- 30.1 In summary, the Applicant submits that while most of the characteristics of the Arrangement described above do not have the purpose, effect or likely effect of substantially lessening competition in any of the relevant markets, it is accepted that an authorisation is required due to the breach of section 30 identified in paragraphs 24.24 to 24.21.

NET PUBLIC BENEFIT

31. DETRIMENT

- 31.1 The Arrangement has a theoretical detriment due to the deemed substantial lessening of competition under section 30 in relation to the price members are to charge non-members for services.
- 31.2 However, the Applicant submits that no actual detriment arises from the deemed substantial lessening of competition when compared with the counterfactual.
- 31.3 Under the regulatory counterfactual the rules will be compulsory; therefore, there will be no supply of services from members to non-members and all industry participants will be bound a single pricing mechanism in relation to each service. Accordingly, the fixing of such prices by the Rulebook cannot cause a detriment relative to the counterfactual. Furthermore, if this section of the Rulebook works as intended, all industry players will become members and therefore the price will never be applied in practice.

31.4 In summary, while there may be a theoretical detriment, the Arrangement has no actual detriments.

32. PUBLIC BENEFIT

32.1 The Arrangement confers the following net public benefits relative to the counterfactual:

- (a) The industry is more likely to make efficient decisions under the Arrangement than the Crown EGB because the industry has the necessary information and faces the appropriate incentives;
- (b) More efficient rules would be made under the Arrangement than under the counterfactual because the industry faces appropriate incentives and is not subject to the same political pressures that would be faced by the Crown EGB and the Minister of Energy;
- (c) The possibility of alternative arrangements developing over time and attracting members away from the Arrangement places a degree of competitive pressure on the Industry EGB and will therefore increase the likelihood that the Arrangement will continue to develop and remain efficient. It is likely that the Arrangement will continually evolve into a more efficient form over time;
- (d) There are greater incentives on the members to comply with the Arrangement than there would be to comply with regulation, since the members themselves have been involved in developing the Rulebook and are therefore more committed to it. In addition, since the industry players agree sanctions for failing to meet standards and for failing to comply with the Rulebook, the sanctions are likely to remain relevant and ensure greater commitment to the Rulebook;
- (e) It is more likely that service provider contracts will be contestable under the Arrangement than under the counterfactual; and
- (f) Under the counterfactual, the Crown EGB may become an "investor of last resort" and, because of the incentives it would face, may authorise investments which are not cost-justified.

Efficient decisions

Appropriate information and incentives

- 32.2 Decisions made under the Arrangement are likely to be more efficient than decisions made under the counterfactual. Such decisions cover everything from day-to-day decisions concerning governance of the industry to the decisions as to the appointment of service providers under new service provider contracts.
- 32.3 The proposed Arrangement should lead to better use of available information and hence higher quality decisions. Better decision-making and hence increased public benefits will occur because decision rights under the Arrangement are allocated within each Part of the Rulebook to the parties involved in the relevant transactions. The parties who are most directly affected by decisions would therefore be making those decisions. These parties will focus resources on making decisions where they consider the benefits will outweigh the costs.
- 32.4 Relative to this, the Crown EGB and future Ministers have weaker incentives to promote the long term efficiency of the industry. The objective of the Crown EGB, as contained in the Electricity Amendment Act 2001 is to "ensure that electricity is generated, conveyed, and supplied to all classes of consumers in an efficient, fair, reliable and environmentally sustainable way". This objective is very broad, and does not provide any constraint on the decisions of the Crown EGB. It enables the Crown EGB to take into account a broad range of considerations in its decision making. There is a risk that decisions will, over time, be made based on political motivations, rather than strictly on economic efficiency grounds.

Implementation of GPS

- 32.5 It is likely that the Crown EGB will be required to implement the GPS and will make decisions based on the requirements of the GPS. The Industry EGB will also likely have regard to the GPS, but will not necessarily make a decision implementing the GPS unless that decision is efficient or effective for the industry as a whole. Working groups who make recommendations to the Industry EGB under the Rulebook will consider whether the GPS requirements make economic sense. While the Crown EGB will also likely involve working groups in decision-making, the Crown EGB and the Minister, who are the ultimate decision-makers, will be subject to political pressures. Although the Industry EGB must have regard to the GPS notified by the Minister of Energy under the Electricity Amendment Act 2001, this is simply an element of the performance of the Industry EGB. In contrast, it is likely that the Crown EGB will be required to act in

accordance with, and implement, the GPS and, in doing so, will pay less regard to whether implementation of policy outlined in the GPS is economically efficient.

- 32.6 For example, the current GPS specifies that the Crown EGB should move urgently to implement real time dispatch prices so as to promote active demand side management (paragraph 18, GPS, Folder of Supporting Material, number 7). However, real time dispatch may increase barriers to entry to demand side management participants and also to small, niche generators who participate in the market periodically.

Regulatory capture

- 32.7 A risk with regulation is that the regulator becomes subject to capture by industry players with substantial market power and government influence. There is a risk of this occurring with the Crown EGB. If this occurs, the effect will be that the Crown EGB will have less incentive to make decisions benefiting the industry as a whole (including consumers), and in its decision making will show some degree of preference for the body or bodies with political influence. The Industry EGB, on the other hand, is less likely to be captured by any one player because it will comprise independent directors with industry knowledge who, in turn, are elected by a complete cross section of industry and consumer interests.

Efficient rules

Information and incentives

- 32.8 Under the counterfactual the Minister, having regard to the recommendations of the Crown EGB, would develop the regulations over time while under the Arrangement the industry would develop rules. As previously discussed, the Industry EGB and working groups who recommend rule changes will have the necessary information and face the appropriate incentives to make efficient rule changes.
- 32.9 Under section IV, Part A, any person may notify a proposed rule change to the Industry EGB which then notifies each participant of the proposed change. For all rule change proposals, the Industry EGB reviews the proposed change and assigns a priority to each proposal. In reviewing the proposal, the Industry EGB may reject vexatious or trivial proposals. Proposals which are not rejected are notified to a working group which has expertise in the relevant area. The working group considers the proposal and recommends to the Industry EGB whether or not the rule change should be made. The Industry EGB selects the members of the working group from nominations received. The Industry EGB must select people it considers have the expertise that meet the selection criteria (set by the Industry EGB) and which results in a balance of interests and expertise appropriate to the working group's terms of reference. The Industry EGB

must have regard to the membership of the parts of the Rulebook that will be affected by the proposal the working group will consider, and to the interests of consumers (Schedule A3).

32.10 If the working group recommends that the proposal be rejected, then the Industry EGB may reject that proposal if it considers that the working group recommendation reflects the proposal and that circumstances have not changed. If the working group recommends the change be made, and the Industry EGB considers that the recommendation reflects the proposal and that no new information has become available, then it can either:

- (a) Put the rule change to a vote (and certain proposals must be put to a vote, as described above); or
- (b) Accept or reject the rule change.

32.11 A rule change may not proceed if:

- (a) the proposed change materially or disproportionately financially disadvantages any member;
- (b) the change is controversial; or
- (c) The board of directors of the Industry EGB has been dissolved and therefore does not have authority to make rule changes.

32.12 Irrespective of whether the Industry EGB decides to accept or reject a rule change, members who hold 25% or more of the votes to be cast on the resolution may give notice to the Industry EGB requiring the decision of the Industry EGB to be confirmed by a resolution. The Industry EGB is, however, given authority to make minor rule changes, such as typographical corrections, for expediency.

32.13 Rule changes requiring regulatory approval, such as under the Commerce Act, may not take effect until the Industry EGB has obtained that approval. The Industry EGB may also delay putting that rule change to a vote until regulatory approval is obtained.

32.14 There is clear industry involvement in the process for rule changes under the Arrangement. The people who are affected by the rule changes are involved in making the changes and therefore have incentives to ensure that efficient changes are made.

32.15 The Electricity Amendment Act 2001 specifies a clear process for making regulations and rules (see in particular sections 172W to 172Z of the Electricity Act 1992 as inserted

by section 16 of the Electricity Amendment Act 2001, Folder of Supporting Material, number 8). In formulating recommendations for regulations and rules for operating the wholesale market and transmission of electricity, electricity governance regulations, and electricity governance rules, the Crown EGB must (section 172X of the Electricity Act 1992):

- (a) have regard to its principal objective (to ensure that electricity is generated, conveyed, and supplied to all classes of consumers in an efficient, fair, reliable, and environmentally sustainable manner (section 172N));
- (b) ensure the recommendations are consistent with any direction given by the Minister, such as a direction by the Minister that the Crown EGB must give effect to a government policy;
- (c) have regard to the following objectives (where relevant):
 - (i) energy and other resources are used efficiently;
 - (ii) risks relating to security of supply are properly and efficiently managed;
 - (iii) the full costs of producing and transporting each additional unit of electricity are signalled;
 - (iv) delivered electricity costs and prices are subject to downward pressure;
 - (v) the quality of electricity services as far as possible reflects customers' preferences;
 - (vi) transmission losses and constraints are signalled; and
 - (vii) consistency with the Government's climate change policies and objectives is achieved.

32.16 In formulating recommendations, the Crown EGB has an obligation to consult with the Minister and with persons that it thinks are representative of the interests of persons likely to be substantially affected by the proposed regulations. However, this does not apply if the Crown EGB considers that it is necessary or desirable in the public interest that the proposed regulations be made urgently, but in that case the Crown EGB must consult within six months of the regulations being made and then decide whether to revoke, replace or amend the regulations as a result.

- 32.17 The Minister must have regard to the recommendation of the Crown EGB, but has a discretion to decide whether or not to act on the recommendation, or defer making a decision on the recommendation, or refer the recommendation back to the Crown EGB for reconsideration.
- 32.18 In making recommendations, the Crown EGB must take into consideration matters considerably wider than simply the efficiency of the industry. The Crown EGB is required to consider matters such as the Government's climate change policies, and any directions given to the Crown EGB by the Minister. For example, the Government has given emphasis to environmental objectives such as energy efficiency and minimisation of greenhouse gases in the GPS (guiding principles, Folder of Supporting Material, number 7) and in the Electricity Amendment Act 2001 (Folder of Supporting Material, number 8). Regulations and rules may therefore be introduced favouring environmental policies which might create substantial costs for participants and significant barriers to entry for entities that do meet the requirements.
- 32.19 Rule changes under the Arrangement are more likely to be aimed at industry efficiency than the furtherance of political objectives, including environmental policies. Therefore, the Arrangement is likely to confer public benefits relative to the counterfactual.
- 32.20 In addition, it is less likely that the Crown EGB and the Minister will have relevant information when making efficient decisions for the industry. There is thus a high prospect that the combination of less relevant information coupled with weaker incentives on the part of the Crown EGB and future Ministers will result in less efficient decision making than will occur under the Arrangement. This has a cost due to non-economic objectives being pursued at the cost of economic policies, as outlined in the expert opinion by Mr Murray and Dr Hansen.
- 32.21 The Crown EGB is therefore more likely to be subject to political pressures in making rule change recommendations than the Industry EGB will be. The Industry EGB can be expected to simply consider the efficiency impact of the proposed rule change, while the Crown EGB must have regard to wider considerations in making recommendations for regulations. In addition, the Minister retains discretion whether or not to make regulations as recommended by the Crown EGB, and the Minister is subject to political pressures and has political objectives. Therefore, the Industry EGB is likely to make more efficient rules than the Crown EGB.

Process

- 32.22 It is likely that rule changes under the Arrangement will be quicker than promulgating new regulations under the counterfactual. Rule changes need not necessarily be

subject to a resolution under the Arrangement, although they must be considered by a working group. However, under the counterfactual the Crown EGB is required to consult with affected parties, and to consider a list of objectives.

32.23 In addition, the recommendations of the Crown EGB are promulgated as recommendations which must be implemented or rejected by the Minister of Energy. This may be a slow process because the Minister of Energy has a broad portfolio of responsibilities, will not be focussed solely on the electricity industry and there can therefore be no certainty that recommendations for rule changes being proposed by the Crown EGB will be consistently given a high degree of priority by future Ministers.

32.24 The Arrangement is likely to make rule changes faster than regulations would be made under the counterfactual. This means that the Arrangement will be more responsive to changing industry needs and more likely to keep pace with developing technology.

Regulatory capture

32.25 As discussed above (see paragraph 32.7), the Crown EGB may be subject to capture by industry players with substantial market power and political influence. These industry players may then influence the outcome of the regulations and rule making process so that the outcome benefits them, although this may not be in the best interests of the industry as a whole. This is unlikely to occur with the Arrangement because:

- (a) decision rights are broadly spread among industry players with competing interests;
- (b) members with sufficient voting rights can cause a resolution to be taken on proposed rule changes; and
- (c) rule changes will be struck down if they are not for the wider benefit of the industry.

Alternative arrangements

32.26 The Rulebook anticipates the possibility that alternative arrangements may develop over time, and that members may choose to resign from the Rulebook and become a part of those alternative arrangements (rule 2, section III, Part A). In contrast, it is likely that the market established under the counterfactual will be compulsory, because this is the nature of regulations. Therefore, the Arrangement confers a benefit because it permits alternative arrangements to arise, which will compete with the market established under the Rulebook.

32.27 The threat of potential alternative arrangements will also place pressures on the Industry EGB to ensure that the Rulebook incorporates efficient changes and new processes where those developments result in continuing evolution of the market into a more efficient form. The Arrangement will effectively face competitive pressure to develop efficiently, otherwise members will resign and join alternative arrangements which offer such efficient new processes. For instance, if a more efficient metering, reconciliation or registry arrangement becomes available, there will be pressure on the Industry EGB to adopt that arrangement for fear that it will otherwise lead to members leaving to establish an alternative arrangement. The Arrangement therefore confers a public benefit relative to the counterfactual by placing pressure on the market to remain efficient and to ensure the processes and services provided to members are efficient.

Incentives to comply

32.28 The Arrangement has been developed by the industry through a lengthy consultation process. All interested parties, including consumer representatives, have been directly involved in the process. In addition, the Ministry of Economic Development and the Minister of Energy have received updates on progress of the project every two months and have publicly supported the industry-led process (see comments of Minister in his statement to the Electricity Networks Association of New Zealand annual general meeting (29 October 2001, Folder of Supporting Material, number 9)). Since all industry players have had a role in developing the Arrangement and sanctions imposed for failing to comply with the Arrangement, it is likely that the industry will be more committed to the Arrangement and have greater incentives to comply than under an externally imposed regulatory regime, particularly to the extent that such regulatory regime evolves over time away from the industry developed solution. In addition, it is likely that the sanctions will remain relevant to both the Arrangement and the offence, and therefore will result in greater compliance with the Arrangement.

Contestable service provider contracts

32.29 The Rulebook enables the service provider contracts to be contestable (after the term of the contracts of the first service providers end, given that the current NZEM service providers will initially continue in their rules to ensure a smooth transition). The Crown EGB will not face such incentives. There is a significant prospect that the Crown EGB will engage Transpower as the permanent system operator to maximise the information available to the Crown EGB so as to facilitate the Crown EGB's advisory role. In relation to several of the other service provider roles, such as market administration, pricing and clearing, it is likely that the Crown EGB will perform these roles because of the information advantages it will give the Crown EGB. Consequently, it is less likely that the Crown EGB will implement contestable service provider contracts, but may either

have permanent service providers or perform some of the service provider roles itself. The counterfactual would therefore be less efficient than the Arrangement. Although the GPS provides for contestable service provider contracts, this may not be applied to the Crown EGB. The Applicant notes that Transpower's 2001/02 *Statement of Corporate Intent*, in contrast to previous statements of corporate intent, does not promote the use of contestable contracts.

- 32.30 The Arrangement is therefore likely to result in a public benefit in relation to the counterfactual because of the likelihood under the Arrangement that the service provider contracts will be contestable, in contrast to the counterfactual.

Investor of last resort

- 32.31 Under the counterfactual, the Crown EGB may become an "investor of last resort" and, because of the incentives it would face, may authorise investments which are not cost-justified.
- 32.32 In particular, the transmission provider will generally find it easier to gain acceptance for an investment proposal from the EGB than from its informed customers. First, the Crown EGB would face little downside in authorising an investment since it would arrange funding from the industry through compulsory levies. Second, the EGB would have a considerable incentive to make investments given the consequences it would face for turning down an investment proposal which subsequently proves necessary. In contrast, the proposed arrangements constrain the ability of the Industry EGB to override industry investment decisions to limited circumstances (see section II of part F).
- 32.33 Further, if transmission investment decisions become politicised, a Crown EGB would face considerable pressure to take a more "hands-on" approach to transmission investment. This suggests that a Crown EGB would focus less on defining service outputs and more directly on securing the investment inputs to keep risk at "acceptable levels". Definition of service outputs is critical for effective competition at the margin where transmission expansions are being considered, since ill-defined service measures make it difficult to compare the relative cost of alternative solutions. Therefore, the counterfactual would be less effective than the proposed arrangement in encouraging substitute providers such as generators and demand-side management.

Summary

- 32.34 In summary, the Arrangement confers considerable public benefits relative to the counterfactual, particularly due to the more efficient decisions and rules that will be made under the Arrangement in comparison with the counterfactual. The benefits

conferred by the Arrangement are substantial, as illustrated in the expert opinion by Mr Murray and Dr Hansen.

- 32.35 The Applicant has not been able to identify any actual detriments arising from the Arrangement, although there is a theoretical detriment due to the deemed substantial lessening of competition. The Applicant submits that the Arrangement will be likely to result in a benefit to the public which would outweigh any lessening in competition that would result, and that the Commission is justified in granting the authorisation sought under section 61 of the Act.

CONFIDENTIALITY

33. CONFIDENTIALITY

Confidentiality is not claimed in respect of the information provided in, or in conjunction with, this notice.

DECLARATION

This application is made by Electricity Governance Board Limited.

I, David Caygill, Director, Electricity Governance Board Limited, am authorised to make this application on its behalf.

I hereby confirm that:

- (a) all information specified by the Commission has been supplied;
- (b) all information known to the Applicant which is relevant to the consideration of this application has been supplied; and
- (c) all information supplied is correct as at the date of this application.

I undertake to advise the Commission immediately of any material change in circumstances relating to the application.

Dated this day of December 2001.

David Caygill

Electricity Governance Board Limited