



MAJOR ELECTRICITY USERS' GROUP

22 February 2002

Mr Bill Naik
Investigator
Commerce Commission
PO Box 2351
WELLINGTON

By email to Bill.Naik@comcom.govt.nz

Dear Mr Naik

Initial submission on EGBL application for authorisation of arrangement(s) that are possibly restricted trade practices

This submission refers to the application by Electricity Governance Board Limited (EGBL) for consideration of an arrangement(s) that may possibly breach the Commerce Act. The application was lodged 6 December 2001 and a clarifying letter tabled 5 February 2002.

This submission is on behalf of members of the Major Electricity Users' Group (MEUG). The members of the group have been consulted in the preparation of this submission.

Nothing in this submission is confidential.

Background to MEUG's interest in the application

The members of MEUG consumer about 32% of New Zealand's aggregate electricity demand per year. If the EGBL application is authorised then the operation of the subsequent authorised rulebook will have a material impact on MEUG members and indeed all end consumers. That material impact will be:

- Directly by way of charges agreed pursuant to the authorised rulebook that inevitably will flow through to consumers; and
- Indirectly by way of changes to common quality that may require changes to end user plant and equipment or operating practices to comply with rules set by those members of the authorised rulebook.

The genesis of the EGBL application arose with the recommendations of the Ministerial Inquiry into the Electricity Industry in 2000, the subsequent release of "the Power Package" in October 2000 and the formation soon after of the Electricity Governance Establishment Committee (EGEC) to work towards a rationalised rulebook. Consistent with those developments a Government Policy Statement and section 26 statement pursuant to the Commerce Act was announced in December 2001 and revised in February 2002. In each of those processes MEUG and MEUG members have been active in making submissions and participating in working groups wherever possible.

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MEUG and MEUG members have actively participated in the EGEC work leading to the application by EGBL. MEUG does not believe the draft rulebook in the application by EGBL is welfare enhancing and has stated its opposition several times to EGEC, Government and publicly. Any consensus claimed by EGBL to the rulebook excludes MEUG and indeed we believe no end consumer or end consumer representative organisation supports the EGBL application.

The importance of this application to the future direction of the electricity industry cannot be understated. The Commission has over the last 6 years considered 3 sets of arrangements for the wholesale market. The first of those was an interim arrangement until the commencement of the New Zealand Electricity Market (NZEM) in October 1996. The second was consideration of the NZEM rules, where the Commission considered authorisation was not necessary as the arrangement was voluntary and parties wishing to trade electricity had an option to elect to use alternative arrangements. The third arrangement was the Multi-lateral Agreement on Common Quality Standards (MACQS) where the Commission authorised the governance arrangements, membership of which is voluntary, but did not authorise any operational or actual cost allocation formula.

The EGBL application differs from all of these prior rules because it is deliberately designed to force mandatory provisions on members and non-members and seeks clearance for detailed operational and cost formula allocation rules and processes.

Scope of the application

EGBL seek consideration of seven groups of rules under the headings:

- Comprehensive coverage provisions;
- Price determination provisions;
- Uniform standards provisions;
- Performance Assurance provisions;
- Transmission Services and Investment provisions;
- Cost allocation provisions; and
- Information disclosure provisions.

These seven groups of rules are not separable, though at first glance they might appear to be. They are an integral part of the entire rulebook because each group includes the rules requiring members to comply with the rulebook in its entirety (Part A Governance Section I General rule 8 Participants must observe the rules).

MEUG assumes EGBL is seeking comprehensive authorisation of the rulebook based on paragraph 7 of their legal counsel letter of 5 February 2002 where they request "that the authorisation cover, in addition to each set of provisions, any "ancillary provisions" which indirectly give effect to the identified provisions." It is inconceivable that the applicant is suggesting the Commission authorise those "ancillary provisions" without knowing exactly what they are or that the applicant has left to the Commission to exactly identify those (that should be the applicants duty) – the only interpretation that can be made therefore is that EGBL wants the entire rulebook authorised.

Jurisdiction

The rules breach the restricted trade practices provisions of the Commerce Act in at least three areas:

- Parts of the rules are exclusionary, ie Part A Governance section IX Services to non-members;
- Other rules are barriers to exit, ie Part A Governance Section III Membership, rule 2 resignation;
- Or are price fixing, eg all of the "Cost Allocation Provision" group of rules and all chapters that are subject to voting allocations where the voters are competing suppliers.

The Commission, in MEUG's view, has jurisdiction to consider each of the seven groups of rules submitted by the applicant because in each of those groups of rules the applicant has included Part A Governance Section I General rule 8 "Participants must observe the rules." This is a comprehensive rule that requires members to abide by all of the rules that apply to their class of membership, including those exclusionary, barrier to exit and price fixing rules as applicable.

As long as there is at least one of the seven groups of rules that lie within the Commission's jurisdiction, then the rulebook if considered as a whole will also be subject to the Commission's jurisdiction.

MEUG believe that the Commission must look closely at the provisions relating to "transitional dispensations". An agreement was reached between the Grid Security Committee and Transpower on a process for "preliminary determinations" which become "transitional dispensations" which if certain pre-requisites occurred become "dispensations" in terms of the rulebook. It is evident from the content of this agreement (and the draft provisions of the rulebook) that existing generators are treated more favourably than new entrants. Whereas the costs incurred by the system operator in procuring ancillary services to cover non compliant plant given a dispensation is explicitly allocated to all participants connected to the grid, new entrants (who seek any form of dispensation from prescribed standards) are specifically obligated to pay for any and all costs that they impose on the system operator. It is arguable that this establishes a barrier to entry. Consumers are cross-subsidising non-compliant plant/assets of existing generators. New generators will not receive any cross-subsidies but will have to face the full costs of their "non-compliance". Their entry into the market may be deterred or prevented notwithstanding they may be the only factor by which pressure can be placed on an incumbent generator, ie new entrants will want to secure hedges which protect their revenue streams.

Market Definition

EGBL submits that there are five functional electricity markets relevant to the application.

We agree that the first four functional markets submitted by the applicant are electricity product related within New Zealand.

The last functional electricity product market labelled by the applicant is "Other services". That market is better described as a generic service provider market with potential providers for all the services listed coming from areas that may not necessarily have a traditional electricity background (eg reconciliation is a data processing skill not necessarily requiring expert electricity knowledge) and can be sourced from overseas (eg in the future an overseas company could become the System Operator). Each of the seven groups of provisions refers to certain requirements of the Clearing Manager and therefore the Generic Service Provider is a relevant market.

For clarity we have listed those functional markets relevant to each of the seven separate groups of rules under consideration and the rules in aggregate as follows:

Groups of rules under Consideration:	Functional electricity product market				Generic Service providers
	Wholesale	Transport	Retail	Ancillary services	
Comprehensive coverage	✓	✓	✓	✓	✓
Price determination	✓	✓	✓	✓	✓
Uniform standards	✓	✓	✓	✓	✓
Performance assurance	✓	✓	✓	✓	✓
Transmission		✓			✓
Cost allocation	✓	✓	✓	✓	✓
Information disclosure	✓	✓	✓	✓	✓
All rules in aggregate	✓	✓	✓	✓	✓

The noticeable feature of the above matrix is that apart from the transmission group of rules, all the other groups of rules have an impact in each of the 5 markets. All of the other rules relate to the operation of the wholesale and retail energy markets (where ancillary services can be considered a necessary adjunct to energy), whereas the transmission group of rules are completely unrelated referring instead to transmission service definition, pricing and cost allocation and new investment decision processes. These rules are unrelated to the energy market but have been collapsed into the rulebook because of the way recommendations emerged from the Ministerial Inquiry in 2000.

The Counterfactual(s)

In the absence of the rulebook proposed by EGLB becoming operational, EGLB submit that the most likely alternative scenario is that the Government will exercise its option pursuant to the Electricity Amendment Act 2001 to establish a Crown Entity EGB.

The applicant's counterfactual is feasible but it is not the only possible scenario. A list of alternative scenarios follows including the applicants counterfactual. These scenarios are ranked in terms of a decreasing role by Central Government, and an increasing role for industry self-regulation coupled with increasing broadly based governance:

- 1) If the application is not authorised the Government will immediately trigger the option in the Electricity Amendment Act 2001 to form a Crown EGB.

EGLB suggest this is the counterfactual. It is noted that the counterfactual scenarios outlined by the applicants expert economic advisors appears to be an "extreme" form of a "quango", ie not responsive in any fashion to industry requirements.

There are problems assuming this would be the most likely outcome. For example experience has shown that the Government does not act "immediately", it will take time to have the machinery of Government draft and Gazette the required regulations and in the meantime EGLB will have strong incentives to seek agreement with parties who have opposed the application. It is also not at all clear exactly what "rulebook" the Crown EGB would start with – it would be unlikely to use the EGLB rulebook if that had not received authorisation from the Commerce Commission and did not have broad based support, particularly from parties ultimately affected, ie consumers.

- 2) If the EGLB application is not authorised the Government may commence steps towards a Crown EGB but the EGLB in the meantime may manage to negotiate a more suitable arrangement to the satisfaction of all parties. There are a number of sub-scenarios possible:

- a) The arrangement might be a mix of a broad-based self-regulating set of rules and a proposition to the Government for a regulation to implement a licensing arrangement enforcing compliance with minimum mandatory rules. MEUG believe that regulation making options within the 1992 Electricity Act (refer Section 169, subsection (7)) could be used to deliver this outcome; or
- b) All parties might be able to agree a self-contained agreement that covers the key issues of broad-based governance and mandatory compliance for a minimum set of mandatory rules.

The risk of these scenarios is that the EGBL and parties opposed to the current EGBL rulebook cannot reach agreement and therefore it inevitably leads to a Crown EGB. But that scenario may lead to other options as the last scenario below describes.

- 3) If the EGBL application is not authorised and irrespective of whether the government commences the long and difficult process of initiating a Crown EGB, the following are likely:

- a) Transpower will continue to use the processes in Part F Transport to establish an initial set of transmission service definitions and conclude consultation on a pricing methodology. This will be complete by later this year and well before any Crown EGB could be formed or indeed an EGB formed pursuant to the EGBL rulebook.

A sub-scenario to be considered is that Transpower seek authorisation of any pricing methodology that emerges from that consultation process. This leads to a question of whether Commerce Commission scrutiny of that transmission pricing methodology will be more efficient and lead to an outcome consistent with pricing methodologies for other natural monopolies than leaving consideration of that methodology to a Crown or stakeholder appointed EGB.

In other words Part F Transport will be implemented irrespective of whether it is authorised as part of the EGBL application or not.

- b) The GSC will continue to manage MACQS and progress important issues such as finalising a Policy Statement and Procurement Plan with the Common Quality Coordinator (CQC, also called the System Operator), managing the conclusion of the proposed change in frequency standards, possibly reviewing frequency procurement options before next years round of contracting by the CQC (this is the most urgent ancillary services procurement issue from a consumer perspective given the very large increases in Frequency Regulating Reserve charges this year) and completing the review of the CQC's role by 31 December 2002 as required under MACQS.

Irrespective of whether the common quality rules are authorised as part of the EGBL application or not the evolution of those rules will continue under the already authorised MACQS governance structure.

- c) A number of rule changes or voluntary arrangements to implement policies in the Government Policy Statement and Winter 2001 Review are already in progress, eg
 - i) Release of bids and offers within 2 weeks is being considered by NZEM and a rule change proposal is imminent. MEUG representatives are on a NZEM working group considering this issue.
 - ii) Mighty River Power has already begun disclosing hydro spill statistics based on a draft set of protocols discussed by all major hydro generators. Other generators may follow that precedent.

- iii) NZEM and Transpower are in the final stage of discussing improvements to real time price information that will assist demand side competition for those trading periods when prices spike. MEUG representatives are on a NZEM working group considering this issue.
- iv) The Electricity Consumer Complaints Commissioner began operating from late 2001, effectively setting aside any urgent need for the development of Part B Consumer issues.

This scenario demonstrates that the EGBL rulebook is largely unnecessary to meet the Government Policy Statement objectives as the existing codes and other developments (eg the Electricity Consumer Complaints Commissioner) have been and will continue to evolve. Note that one of the drivers of the EGBL rulebook was to gain efficiencies from merging the codes. In the above scenario the parties who bear the costs directly and indirectly will continue to have an incentive to rationalise the rulebooks where the benefits exceed the costs.

Public Benefits and Costs

The applicant argues their rulebook is beneficial compared to a Crown EGB because industry will be closer to the rule making process, will have better incentives and commitment to rules they control and have less risk of political interference. MEUG is sceptical of these benefits. It is not at all clear that consumer welfare and the nation's welfare will be maximised by competing suppliers making decisions rather than a Crown EGB subject to greater public scrutiny.

In our experience suppliers have not acted in the interests of consumers in either NZEM or MARIA, unless they have been subject to intense external political pressure from consumers or by direct Government signalling of desired policy options.

The applicant's proposal depends on the proposition that only directly contracting parties should have decision rights over rules that affect the property rights of those parties. This ignores the "agency" problem of assuming those directly contracting parties will in turn adequately reflect the interests of consumers. It also ignores the widely accepted principle that those parties who may be "economically advantaged or disadvantaged" are indeed stakeholders and therefore must be entitled to vote on issues which affect their welfare.

Each of the three scenarios and various sub-scenarios suggested in the preceding section we believe would be welfare enhancing relative to the case where the Commission authorises the EGBL rulebook. The key benefit of these scenarios is that development of more broad-based self-regulating arrangements would emerge and this will reduce the "agency" problem discussed above.

If the application currently before the Commission is authorised there will be ongoing costs to the economy of managing the political pressure that consumers will mount to overturn the new rulebook and the biased governance arrangements. This consumer backlash is not a threat, it is a forecast based on our experience to date in having great difficulty in having a fair and timely hearing before NZEM or MARIA to consider issues and proposed rule changes that concern consumers. An authorised EGBL rulebook would entrench the current dominance over rulemaking with suppliers (and will in fact reduce existing decision rights held by consumers over common quality and security rules under MACQS). Unless there is a factor we have not thought of, we cannot see supplier behaviour changing.

The applicant has provided Discounted Cashflow calculations on their claimed benefits relative to the counterfactual. Those calculations do not take into account the backlash from consumers outlined in the previous paragraph.

Concluding comments

In summary MEUG make the initial comments on the EGBL application:

- The rules in aggregate and each of the seven groups of provisions submitted by the applicant either have rules that are exclusionary, create barriers to exit, are deemed to be price fixing or require overall compliance with the rules that encompass these restricted trade practices. Therefore MEUG believe the Commission has jurisdiction to consider the seven groupings of rules and the rules in aggregate.
- Intense scrutiny of the “preliminary determination/transitional dispensation/ arrangements” are required as it is not clear that the applicant has recognised the anti-competitive nature of these arrangements.
- All of the rules, other than the Transmission Service Definition and Investment Provisions, affect all 4 functional electricity product markets and the generic service provider market. The Transmission Service Definition and Investment Provisions affect only the Transport and generic service provider markets.
- A regulated Crown Entity EGB as proposed by EGBL as the counterfactual is one of many feasible scenarios; it is not the only scenario. There are practical and timing problems with the applicant’s counterfactual. If the application is not authorised most of the Government’s policies set out in the Government Policy Statement will be implemented anyway, other than rationalisation of the three industry codes. And EGBL and parties opposed to the current rulebook will have an opportunity to negotiate a more broad based arrangement. Even if that is unsuccessful the incentive on consumers and the industry to gain efficiencies from rationalising the existing codes will remain.
- EGBL have not included the backlash cost from consumers should the application be authorised. This backlash cost will arise because inevitably consumers interests will not be adequately taken into account of by those with voting rights on various chapters and consumers will politicise and use other avenues to remedy that “agency” problem. MEUG’s alternative scenarios have the benefit of a broad based governance structure that will be more sustainable and will lead to better decisions.

We look forward to participating in the Commission’s further consideration of this application.

Yours sincerely

Ralph Matthes
Executive Director