ELECTRICITY GOVERNANCE BOARD LIMITED

APPLICANT'S SUBMISSIONS ON COMMERCE COMMISSION'S DRAFT DETERMINATION

22 MAY 2002

COMMERCE ACT 1986: APPLICATION FOR AUTHORISATION
SUBMISSIONS ON COMMERCE COMMISSION'S DRAFT DETERMINATION

Date: 22 May 2002

The Registrar
Business Acquisitions and Authorisations
Commerce Commission
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Submissions on the Commerce Commission's Draft Determination dated 26 April 2002 are hereby made by:

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1. INTRODUCTION

Background

1.1 The Electricity Governance Board Limited ("**Applicant**") has sought authorisation to enter into and give effect to an arrangement between participants in the electricity industry that will restructure the basis under which the industry trades electricity. The proposed Arrangement (as defined in the original application dated 7 December 2001) represents the outcome of a lengthy process of consultation amongst industry participants in response to the Government's requirement that the industry develop a contractual arrangement of its own making or face regulation, for which it has made provision already in the Electricity Amendment Act 2001.

1.2 In its Draft Determination published on 26 April 2002, the Commission confirmed that government regulation (establishing a Crown EGB) was the correct counterfactual, but reached the preliminary view that the public benefits of the proposed Arrangement would not necessarily outweigh the public detriments.

1.3 The Applicant submits that the public benefits are greater, and the public detriments substantially less, than were assessed by the Commission. The Applicant submits that on the basis of the re-assessed benefits and detriments the authorisation should be granted.

1.4 Alternatively, the authorisation could be granted subject to conditions to further tilt the balance of benefits and detriments in favour of granting the authorisation. Although the Applicant and the Electricity Governance Establishment Committee ("**EGEC**") are strongly of the view that the Arrangement should be authorised in its present form, EGEC has asked its Governance Working Group ("**GWG**") to consider rule changes which could become conditions upon which the authorisation might be granted (see paragraphs 10.6 to 10.8 below).

The choice presented by the Arrangement and the counterfactual

1.5 The Applicant endorses the broad thrust of the counterfactual of government regulation adopted by the Commission. It follows from this counterfactual that whether or not the Commission authorises the proposed Arrangement will determine whether the industry continues to self-regulate or there is a return to centralised regulatory decision-making.

1.6 The Applicant submits that there are a number of key differences between self-regulation and a Crown EGB which are central to the assessment of the benefits and detriments of the proposed Arrangement:

(a) *Knowledge*

Industry participants as members of the Rulebook have the best knowledge base from which to make decisions about the rules under which the industry should operate.

The directors of the Industry EGB would be both knowledgeable as to industry matters and independent.

Working groups drawn from active industry participants will have a key relationship with the Industry EGB as set out in Part A of the Rulebook and will provide additional valuable input and resource on which the Industry EGB can draw. This arrangement has no counterpart in a Crown EGB structure.

(b) *Motivation & Independence*

The Guiding Principles (in the case of all participants and bodies) and economic self-interest (in the case of industry participants), will motivate industry participants, the Industry EGB and the Rulings Panel to evolve the Rulebook over time so it remains as efficient as possible. Similarly, under the proposed Arrangement, transmission investments will be based on the costs and benefits of investment. In contrast, the Crown EGB and the Minister as final decision maker will be subject to a different set of motivations. Comparing motivations under the proposed Arrangement and the counterfactual:

- The Industry EGB is under a duty to facilitate the rule change process and recommend ways of better promoting the Guiding Principles (Part A, section II, Rules 1.2.3 and 2.2.1).

- The decision rights under the Arrangement are designed so that those who face the costs and benefits of decisions make the decisions.

- A Crown EGB would carry a significant risk of regulatory capture, particularly by one or more of the SOEs.

- A Crown EGB may authorise transmission investments which are not cost-justified as it will not face the financial costs of investment, but will face political criticism and sanction in relation to grid security issues if investments are not made.

- This same reasoning may mean that the Crown EGB will not pursue pro-competitive rule changes which are opposed by the service provider on the basis of grid security concerns.

- A Crown EGB may also "crowd out" private investor competition in transmission services because of an inherent institutional bias in favour of investment by the existing provider.

- There is no evidence that industry voting under the present NZEM arrangements results in pro-competitive rule changes being blocked.

- Under the Industry EGB, the Rulings Panel will be able to reject rule changes which do not comply with the Guiding Principles. "Non-economic" policies will be more easily pursued by the Crown EGB.

(c) *Decision-making quality*

- Central planning processes tend to fail to anticipate risk adequately, or to allow for physical, institutional, and human problems, and to present overly optimistic cost and demand estimates.

  In section 4 of the expert report, LECG/Murray & Hansen ("**LECG**") refer to a World Bank review of over eighty hydro electric projects completed in the 1970's and 1980's which bears out this pattern of poor centralised decision-making.

(d) *Speed of adapting to changed circumstances*

The speed of rule changes will also likely be greater under an industry arrangement, resulting in an arrangement more responsive to changing industry needs and more likely to keep pace with developing technology:

- Rule changes under the counterfactual require regulations to be promulgated, which can only occur after consultation with affected parties, consideration of a list of objectives and Ministerial approval.

- The Industry EGB will be able to prioritise rule changes.

Structure of these submissions

1.7 This submission is structured as follows:

(a) Outline of comments on the Draft Determination and identification of key points of difference: section 2.

(b) Analysis of each of the key points of difference:

(i) Price fixing: section 3

(ii) Guiding Principles: section 4

(iii) Pro-competitive Rule Changes: section 5

(iv) Transmission Under-investment: section 6

(v) Competitiveness of the Transmission Market: section 7

(vi) Comprehensive Coverage: section 8.

(c) Reassessment of the Public Benefits and Detriments: section 9.

(d) Other Issues: section 10

(i) Future Amendments to Rulebook

(ii) Extension of Application

(iii) Possible Conditions on Authorisation.

(e) Appendices:

(i) Answers to Commission's Questions

(ii) Legal Issues: Section 30 and Price Fixing.

1.8 This submission is accompanied by the expert economic report of LECG, which was asked to comment on the matters listed in paragraphs (b) and (c) above.

2. OUTLINE OF COMMENTS ON THE DRAFT DETERMINATION

2.1 This section of the submissions follows the main headings of the Draft Determination and identifies key points on which the Applicant's views diverge from those of the Commission.

The Application / Commission Procedures / Background / Current Market Arrangements / The Proposed Arrangements / Industry Response to GPS (paras 1-88)

2.2 Other than the views expressed in the answers to the Commission's questions as set out in Appendix A, the Applicant has no comment in relation to these parts of the Draft Determination.

Market Definition (paras 89-103)

2.3 The Draft Determination accepts the market definitions proposed in the authorisation application (paras 101-102), except that the Commission groups "other services" as a single market. The Applicant accepts this approach, as it does not believe that anything turns on this distinction.

Application of the Commerce Act 1986 and Section 30 (paras 104-148)

2.4 The Commission concluded that the proposed Arrangement breaches section 30 in three respects (charges to non-members (para 137), transmission pricing methodology (para 142) and cost allocation (para 147)) and that wholesale bids, offers and the price determination mechanism *may* breach section 30 (para 133).

2.5 The Applicant disagrees with this part of the Draft Determination. The Applicant's submissions on this issue are summarised at section 3 below and set out in full in Appendix B.

The Counterfactual (paras 149-188)

2.6 The Draft Determination largely accepts the counterfactual of a Crown EGB proposed by the Applicant. In particular, it accepts that the operational rules under the counterfactual would be the same, or very similar, to the operational rules specified in the proposed Arrangement (paras 185-187). The Draft Determination also accepts that, while starting from the same position, the counterfactual would evolve differently from the proposed

Arrangement in light of the different information, incentives and constraints on the Crown EGB and the Minister of Energy as decision-makers compared with the voting members in the proposed Arrangement.

2.7 Subject to the comments below, the Applicant agrees with this approach.

Differences between Proposal and Counterfactual (paras 189-355)

2.8 The Draft Determination found that the proposed Arrangement and the counterfactual did not differ with respect to Part C Common Quality (para 277), Part D Metering (para 281), Part E Customer Switching (para 283), and Part I Implementation and Transition Issues (para 352). The Applicant accepts these assessments. In relation to Part I, the Applicant notes that the Grid Security Committee has clarified that the duration of certain transitional arrangements may well exceed six months.

2.9 The Draft Determination also notes areas of possible difference between the proposed Arrangement and the counterfactual. The Applicant broadly agrees with the existence of these differences, but disagrees with the Draft Determination in relation to the benefits and detriments which result from these differences:

(a) Guiding Principles

The Draft Determination notes that the Guiding Principles differ from the GPS in some respects and states that such differences mean that the proposed Arrangement may harm consumer welfare compared with the counterfactual (para 222). The Applicant submits that the Guiding Principles will implement the GPS in a practical and workable manner and that, if anything, a benefit should be attributed to the differences. The Applicant summarises this argument at section 4 below and refers to section 2 of the LECG report.

(b) Pro-competitive Rule Changes

The Draft Determination expresses a concern that voting allocations for some chapters of the Rulebook will be concentrated in the hands of vertically integrated generator-retailer companies and that existing market participants may have incentives to block or delay rule changes that would have the effect of lowering barriers to entry or enabling greater competitive discipline (paras 223-243). The Applicant submits that the risks of pro-competitive rule changes not occurring is in fact greater under the counterfactual than the proposed

Arrangement. The Applicant summarises this argument at section 5 below and refers to section 3 of the LECG report.

(c) Comprehensive Coverage

The Draft Determination concludes that the mandatory nature of the proposed Arrangement would preclude the possibility of competition developing in the provision of administration, pricing and clearing services, which the Commission considers might be available on a competitive basis in the counterfactual (para 262). The Applicant addresses this point below in section 8 and refers to section 6 of the LECG report.

(d) Transmission Under-Investment

As with the pro-competitive rule change issue above, the Draft Determination expresses a concern about voting allocations, this time in relation to distributors, who the Commission considers would not necessarily have an interest in approving investments to relieve transmission constraints (paras 329-332). The Applicant submits that the Commission's concerns stem partly from a misinterpretation of Part F, and that transmission under-investment is unlikely under the proposed Arrangement. The Applicant summarises this argument at section 6 below and refers to section 4 of the LECG report.

Public Benefits and Detriments (paras 356-447)

2.10 The Applicant's assessment of the benefits and detriments stemming from the proposed Arrangement differs from the Commission's assessment for the following reasons:

(a) The Applicant's view of the consequences of the differences between the proposed Arrangement and the counterfactual referred to in paragraph 2.9 above, differs from the view expressed by the Commission in the Draft Determination; and

(b) The Applicant also disagrees with the Commission in relation to its treatment of the appropriate measure of dynamic efficiency, the treatment of cost of capital issues with respect to SOEs, and the effect of the counterfactual on competitiveness in transmission services. The Applicant outlines these arguments at sections 7 and 9 below and refers to sections 5 and 7 of the LECG report.

2.11 The reassessed public benefits and detriments of the Arrangement starting from the Draft Determination, but incorporating the Applicant's arguments outlined above, are set out in section 9 below. The full reassessment is contained in section 7 of the LECG report.

Summary of Key Points of Difference

2.12 As outlined above, the Applicant considers that there are six significant points on which it disagrees with the Commission's Draft Determination:

(a) Price Fixing;

(b) Guiding Principles;

(c) Pro-competitive Rule Changes;

(d) Transmission Under-investment;

(e) Competitiveness in Transmission Services; and

(f) Comprehensive Coverage.

2.13 Each issue is discussed in turn.

2.14 Following on from that discussion, the Applicant outlines a re-assessment of the public benefits and detriments in relation to each of the key points of difference, and the additional issues of cost of capital and dynamic efficiency.

3. PRICE FIXING

3.1 In relation to possible breaches of the Act, the Draft Determination reaches the following conclusions in relation to section 30:

(a) Wholesale bids, offers and the price determination mechanism *may* breach section 30;

(b) The stipulated price for members to charge non-members breaches section 30. This point was conceded in the application;

(c) The Part F method for determining the transmission pricing methodology breaches section 30; and

(d) The cost allocation provisions breach section 30.

Given that the Applicant always accepted that the proposed Arrangement breached section 30 in at least one respect (that is, the stipulated price for members to charge non-members), adverse findings in relation to points (a), (c) and (d) do not affect the authorisation application.

Implications of the Draft Determination

3.2 However, if the Commission determined finally that the wholesale market, the transmission pricing methodology and the cost allocation provisions breach section 30, then this would have significant consequences for industry arrangements and the need to authorise any subsequent changes to these sections of the Rulebook, as well as ramifications for many other price determining processes and cost allocation mechanisms in the wider economy.

Submission

3.3 In short, the Applicant submits that section 30 does not extend to arrangements which merely provide a process for allowing a price to be set in response to changes in supply and demand. A sophisticated commodity - such as electricity, futures or equities - can only be traded in a sophisticated market which has imported certain trading rules; section 30 was not intended to prevent the formation of such a market. A rule to *find*, rather than *fix,* a price is non-infringing.

3.4 It is also submitted that section 30 does not prohibit arrangements under which competitors share a common input, unless they interfere with the normal forces of supply and demand for the good or service in the market in which they compete.

Conclusion

3.5 For the reasons set out fully in Appendix B to this submission it is submitted that the operation of the wholesale market, the transmission pricing methodology and the common cost allocation provisions do not breach section 30.

4. GUIDING PRINCIPLES

4.1 The Applicant does not accept that any divergence between the Guiding Principles and the GPS creates a potential for the proposed Arrangement to lessen competition, or otherwise harm consumer welfare, compared with the counterfactual. In fact, for the reasons detailed in section 2 of the LECG report, the Applicant submits that the Guiding Principles will effectively implement the GPS and that, if anything, the Guiding Principles are likely to give rise to benefits for the proposed Arrangement relative to the counterfactual.

Premise

4.2 The premise underlying the Commission's concern is that the Crown EGB would adopt the GPS rather than something more like the Guiding Principles. This is not at all certain, and as the Commission itself put it (para 220):

> …the Crown EGB in the counterfactual would have Guiding Principles **based on** the principles and objectives in the GPS. [emphasis added]

The proposed Arrangement also has Guiding Principles based on the principles and objectives of the GPS. The degree of divergence is not assessable in the abstract because a Crown EGB would be expected to recognise the same sorts of practical issues that resulted in the development of the Guiding Principles by the Applicant and its Governance Working Group.

4.3 It should also be noted that the Applicant had two intensive consultation rounds on the Guiding Principles with officials from the Ministry of Economic Development, who were charged by the Minister to focus closely on the Guiding Principles.

4.4 A further, distinct point is that Part XV of the Electricity Act provides for the Industry EGB to agree performance standards annually with the Minister - which standards will reflect the GPS - and the EGB's compliance with those standards are monitored by the Auditor General and Parliamentary Commissioner for the Environment. This process will constrain the degree of divergence between the operation of the Guiding Principles in practice, and the GPS principles and outputs.

Consistency

4.5 There is in fact a high level of consistency between the Guiding Principles and the GPS (refer section 2.4 of the LECG report). Both are primarily a set of high-level statements about desired outcomes and processes, the purpose of which is to:

(a) provide guidance, stability and consistency in uncertain times and situations; and

(b) provide assurance to parties who are affected by the arrangements that they will governed in a consistent and rational manner.

4.6 Further, the Guiding Principles follow the existing multilateral arrangements (MARIA, MACQS and NZEM) very closely. By retaining wherever possible the language from the existing codes (while remaining consistent with the GPS), the industry retains as much as possible of the six years of precedent and understanding developed through the use of Guiding Principles in rule making under the existing codes.

Divergence desirable

4.7 Given this common purpose, the relevant question is not how consistent the Guiding Principles are with the GPS, but rather whether they are superior or inferior to it in performing their intended role of providing high-level guidance and assurance of consistency and stability.

4.8 The guiding principles section of the GPS is not well expressed in terms recognisable as principles that could be inserted into a legally binding contract. The Guiding Principles are likely to perform better their intended role because they are likely to be more enduring than the GPS in terms of changes made to specific policy outputs in the GPS. The Guiding Principles also have less potential for conflicts, and higher discriminatory power, than the GPS (refer section 2.5).

Robustly reviewed

4.9 In addition to extensive consultation with officials, the Governance Working Group discussed the Guiding Principles on six separate occasions over a seven-month period from December 2000 to June 2001. The Guiding Principles have been assessed, and peer-reviewed, in detail based on five criteria, namely that the Guiding Principles be self-evident in their merit, enduring, comprehensive and encompassing, avoid the potential for conflicts between principles and possess discriminatory power. The process is discussed in detail in section 2.5 of the LECG report.

Conclusion

4.10 Accordingly, the Applicant submits that not only does any divergence not result in any detriment, it in fact gives rise to public benefits relative to the GPS.

5. PRO-COMPETITIVE RULE CHANGES

5.1 The Commission considered that under the proposed voting arrangements, some pro-competitive rule changes, for example lowering barriers to entry or enabling competitive discipline, would be blocked or delayed by existing market participants. It considered that while this may also occur under the counterfactual, it is likely to be of greater competitive significance with the proposed Arrangement (paras 223-243).

5.2 The Applicant requested that LECG evaluate the analysis in the Draft Determination in relation to pro-competitive rule changes. For the reasons outlined below, they have assessed that the proposed Arrangement is likely to be pro-competitive relative to the counterfactual.

Industry self-governance generally more efficient

5.3 The risk of strike down of pro-competitive rule changes identified by the Commission is a potential risk in any industry-based decision making structure, and it is also a risk under the counterfactual. However:

(a) industry self-governance generally results in more efficient outcomes over time, after allowing for the risk of strike down of pro-competitive rule changes; and

(b) the risk of self-interested voting by incumbents against reductions in entry barriers can be mitigated through:

(i) the continued jurisdiction of the Commerce Commission; and

(ii) regulatory threat from the Government - which remains a real threat under the proposed Arrangement given the terms of the Electricity Amendment Act 2001.

NZEM experience contradicts prediction

5.4 Second, empirical analysis of member voting under NZEM (sections 3.7 and 3.8 of the LECG report) also suggests that concentrated voting allocations are not an actual cause for concern. Under the class voting structure of NZEM, generators have had the potential to inhibit pro-competitive rule changes since October 1996. They have not done so.

5.5 NZEM records show that all pro-competitive rule changes put to the vote were adopted. The substantial majority of pro-competitive changes received 100% vote in favour from both generator class and purchaser class participants.

5.6 Nor was there any evidence to suggest that pro-competitive rule changes were subject to any greater delay in pre-voting processes than rule change proposals that were competitively neutral.

Better processes under proposed arrangements than NZEM

5.7 Third, while concentrated voting allocations have not been an issue under NZEM, the proposed Arrangement actually improves on the process in NZEM (section 3.4 of the LECG report). This further reduces the risk of pro-competitive rule changes being delayed or struck down. In particular, an independent Industry EGB can ensure pro-competitive rule changes are given appropriate priority.

Risks higher under counterfactual

5.8 Finally, the LECG report has identified a risk that under a Crown EGB pro-competitive rule changes which permit greater diversity and differentiation might be blocked by the transmission provider and the system operator (section 3.7 of its report). New technologies may be perceived to potentially affect the operation and commercial viability of complementary assets (e.g. the national grid) and services (e.g. the system operator role), which provides the transmission provider and the system operator with strong incentives to promote uniform standards and processes, and to take a reactionary approach to pro-competitive rule changes.

5.9 As the incentives identified are inherent to the transmission provider and system operator roles, and thus would apply under both the proposed Arrangement and the counterfactual, the key issue becomes which institutional structure provides a countervailing incentive to ensure outcomes are efficient overall.

5.10 The proposed Arrangement provides this balance, by allocating voting rights to members whose rights are affected by the actions of the transmission provider and system operator. In contrast, the structure under the counterfactual allocates the decision to the Minister, at least in relation to regulations, on recommendation of the Crown EGB. For the reasons given by LECG, this has the potential to result in an effective veto right held by the transmission provider and system operator, exacerbating the risk of strike down of pro-competitive rule changes.

Conclusion

5.11 The Applicant submits that the proposed Arrangement therefore confers a net public benefit relative to the counterfactual. Even if this approach is rejected by the Commission, it has noted that consistent voting down of pro-competitive rule changes would be readily transparent and might lead to government intervention under the Electricity Amendment Act 2001.

5.12 LECG assesses that a "wait and see" policy is optimal, as the maximum cost of waiting is the temporary delay in the introduction of pro-competitive rule changes, whereas the maximum loss from declining an authorisation is the permanent gain from more efficient rule making under the proposed Arrangement (see Annex 3 of the LECG report).

6. TRANSMISSION UNDER-INVESTMENT

Background

6.1 Transmission investment is important to maintain grid security and quality of supply and to increase the size of the electricity generation/consumption pool to improve competition.

6.2 Transmission investment is likely to be impeded by vague service definitions, unclear price signals, the ability to free-ride and ambiguity over who the customers are.

6.3 Part F of the proposed Arrangement is intended to address the contracting problems to new investment by reducing ambiguity over service levels and prices, creating a process for forming investment coalitions and overcoming holdout problems (see section 4.7 of the LECG report).

The Commission's view

6.4 The Commission took the view that the proposed Arrangement could lead to under-investment in transmission assets relative to the counterfactual (paras 439-444) because:

(a) electricity lines businesses would likely hold the majority of voting rights in future investment decisions (because lines businesses have historically paid for most of Transpower's costs);

(b) electricity lines businesses have only weak incentives to approve investments to relieve transmission constraints (but would likely support investments to maintain security and quality of supply); and

(c) a Crown EGB established under the Electricity Act would force investments that result in a net public benefit.

6.5 The Applicant submits that this view is incorrect.

Decision-making under the proposed Arrangement

6.6 In relation to issues (a) and (b) above, the Applicant submits that the Commission may have misinterpreted the way in which votes are allocated in relation to new investments under Part F of the Rulebook.

6.7 On the basis that transmission payments are currently sourced from distributors and generators in the ratio of approximately 4:1, the Commission infers that distributors would hold the majority of voting rights in future investment decisions. However, the identity of the parties which might form a coalition for a transmission investment is not pre-determined by Section II of Part F and is not based on shares of historic costs. Any parties that would benefit from an investment, whether they are lines companies, retailers or end users, are entitled to form coalitions sufficient to support the investment. Parties who have no incentive to support an investment need not be part of a coalition and need not be allocated votes.

6.8 Given the infrequent and high value nature of transmission investment decisions, as LECG argues in section 4.8.1 of its report, the parties are likely to be able to overcome the transaction costs in forming such coalitions. The NZEM voting history supports the argument that coalitions can be formed to support beneficial group decisions.

Decision-making under the counterfactual

6.9 As to issue (c), the Commission considers that a Crown EGB established under the Electricity Amendment Act would force investments that result in a net public benefit where the parties concerned are unable to reach agreement. However, a Crown EGB would face high transaction costs in interpreting transmission customer preferences and determining price, quality and method of delivery.

6.10 In addition, the mandating of investments by a Crown EGB would risk the creation of significant public detriments because:

(a) A Crown EGB would face the difficulties of any central planner making investment decisions (evidence referred to by LECG in section 4.9 of its report illustrates such risks);

(b) Investment decisions by a Crown EGB could “crowd out” private investors as:

(i) regulation would give Transpower secure returns for its investments, whereas private investors would bear the risk of developing and marketing alternative solutions; and

(ii) potential private investors may also have to pay for the Transpower services they would like to replace as they are likely to be existing customers such as lines companies and generators; and

(c) Forcing lines companies to pay for investments they did not otherwise support increases financial risk if they bear those costs and, if they can pass on these costs plus a margin, they will be incentivised to promote inefficient investment.

Quantum meruit

6.11 The Commission has also raised the issue (based on a submission from Transpower), whether the use of the doctrine of quantum meruit in the Rulebook creates uncertainty and is likely to reduce investment by transmission providers.

6.12 It is submitted that it would not. The process prescribed in Part A, section IX of the Rulebook (whereby the EGB takes responsibility to recover payments from non-members receiving services) is designed to ensure that there is an effective and rigorous process of recovery to avoid free-riding, a common sharing of credit risk, and above all to encourage participation so that resort to quantum meruit is not necessary. However, if resort to that principle is required, the establishment of quantum meruit pricing is not expected to be unduly complicated, and requisite principles would soon be settled. Concerns about the process in the recent past have had to do with the unwillingness of the transmission provider to provide a platform for debate of its methodology - which will effectively no longer be relevant given the industry-wide process in Part F section III - rather than whether the principle is effectual.

Conclusion

6.13 The Applicant submits that there is no reason to expect that the proposed Arrangement will lead to under-investment relative to the counterfactual and that, to the contrary, there is a significant risk of competitive investment being crowded out by a Crown EGB.

7. COMPETITIVENESS OF THE TRANSMISSION MARKET

Counterfactual vs Proposed Arrangement

7.1 In its Draft Determination the Commission accepted that operational efficiency would be under less pressure in the counterfactual relative to the proposed Arrangement (para 428). This was said to result from the fact that an industry participant's ability to monitor and influence Transpower would be moderated by risk aversion in the Crown EGB.

7.2 However, the Commission concluded that the majority of efficiency gains achieved by Part F of the Rulebook would also be achieved under the counterfactual, on the basis that the Crown EGB would have the necessary information, incentives and capabilities to prevent entry barriers against substitute services for transmission. It accordingly assessed the magnitude of the gains as minimal, an average of 0.55-1.1% (para 459). This was in stark contrast to LECG's assessment, which assessed the average gain at 8%.

Submission

7.3 The Applicant submits that the operational gains under the proposed Arrangement are likely to be significantly higher than under the counterfactual:

(a) As outlined above in relation to transmission under-investment, there is a risk that a Crown EGB would "crowd out" private investors, creating a high probability of detriments as a result of reduced rivalry and competitive pressure (paragraph 6.10(b) above).

(b) A Crown EGB would also be influenced by expert advice with a strong bias towards transmission solutions as opposed to substitutes for transmission (paragraphs 5.8 to 5.10 above) .

Conclusion

7.4 For these reasons, the Applicant submits that the efficiency gains under the proposed Arrangement are significant and give rise to a public benefit relative to the counterfactual.

8. COMPREHENSIVE COVERAGE

8.1 In its Draft Determination the Commission questioned the potential for competition to develop in the provision of administration, pricing and clearing services under the proposed Arrangement and the counterfactual. It concluded that such services may become available on a competitive basis under the counterfactual, but that this would not occur under the proposed Arrangement.

8.2 The Applicant notes that, like the other service provider roles, the market administration, pricing management and clearance management roles are all *contestable* under the proposed Arrangement (refer Part A, Section VI of the Rulebook). (The other service providers are the system operator, the reconciliation manager and the registry.)

The basis for comparison

8.3 The Commission accepted that the operational rules as specified in the proposed Arrangement would initially be adopted by a Crown EGB. As such, any move to allow competition for administration, pricing and clearing services would not occur until after the rules had become operational. Thus in order to compare the potential for development of alternative trading arrangements under the proposed Arrangement and the counterfactual it is necessary to consider:

(a) The application of the existing rules - How would the decision makers under the proposed Arrangement and the counterfactual differ in their application of the rules?

(b) The potential to alter the rules - If the initial rules proved inadequate, how would the rules evolve under the proposed Arrangement and the counterfactual?

Application of existing rules

8.4 In relation to application of the proposed rules, the Applicant submits that a Crown EGB and an Industry EGB would be equally conservative in approving resignations from the Rulebook when faced with lobbying from parties concerned about system security, free-riding and cross-subsidisation (see section 6.2.1 of the LECG report).

8.5 This conservatism is likely to be supplemented by the transmission provider and system operator who face strong incentives to promote a single trading arrangement, and

whose agreement is required if a resigning member wishes to continue to participate in the electricity industry. In order to have its alternative arrangements approved, the resigning member must reach agreement with the transmission provider and system operator in relation to continued provision of their essential services. The transmission provider and system operator thus hold an implicit veto on the development of any new arrangement.

Potential to alter the rules

8.6 In terms of the evolution of the Rulebook, the Commission suggests that rule changes to permit choice over pricing, administration and clearing services would be implemented under the counterfactual, but not under the proposed Arrangement.

8.7 First, the Applicant submits that if it is efficient to make these services competitive, the industry will have no incentive not to. Accordingly, there is no difference in the likelihood of such changes occurring under the proposed Arrangement compared with the counterfactual. Indeed, if anything, the industry will be better placed to assess the desirability of competition in pricing, administration and clearing services.

8.8 Second, in light of the potential for government intervention, discussed at paragraph 5.11 above, the public detriment resulting from any difference identified between the proposed Arrangement and the counterfactual will be minimal (see section 6.2.2 of the LECG report).

Conclusion

8.9 For the reasons outlined, the Applicant submits that competition in the provision of administration, pricing and clearing services is equally as likely to develop under the proposed Arrangement as under the counterfactual, and accordingly that no public detriment arises.

9. REASSESSMENT OF THE PUBLIC BENEFITS AND DETRIMENTS

9.1 In the Draft Determination, the Commission assessed the total net present value of:

(a) public benefits at $59m - $118m; and

(b) public detriment at $62m - $127m.

9.2 LECG has reassessed these figures based on the matters referred to in the previous sections and several technical matters referred to below.

9.3 The following table, taken from page 42 of the LECG report, summarises the results of this reassessment:

Table 2: Summary of new estimates								
	Draft Determination			***LECG new assessment***			***Difference***	
	NPV ($m)			***NPV ($m)***			***(midpoint)***	
Public benefits under proposed arrangement								
Lower cost of capital	11	to	22	28	to	57	26	
Comparative advantage of industry decision-making (Note 1)	28	to	57	45	to	90	25	
Lower transaction, compliance and lobbying costs	6	to	12	6	to	12	0	
Strike down risk from transmission & system operator		-		50	to	105	77	
Avoidance of over-investment in transmission (Note 2)	10	to	20	10	to	20	0	
Competition in transmission services (Note 3)	1	to	2	10	to	20	14	
Competition in service provision	3	to	6	3	to	6	0	
Total	**59**	to	**119**	**152**	to	**310**	**142**	
Public detriments under the proposed arrangement								
Under-investment in transmission	29	to	54		-		-42	
Strike-down risk from generator/ retailers (Note 4)	33	to	72		-		-53	
Total	**62**	**to**	**127**	**0**	**to**	**0**	**-94**	
Additional qualitative assessments								
GPS vs. Guiding Principles	Potentially -ve			+ve				
Comprehensive coverage	-ve			neutral				
Notes:								
1. The new assessment incorporates the "Market Value" base for dynamic efficiency, but otherwise is the same as the Draft Determination.								
2. The number shown for the Draft Determination is the amount in Table 3 of Draft Determination less the operating efficiency gains shown in that table								
3. The number shown for the Draft Determination is the operating efficiency gain shown in Table 3 of the Draft Determination								
4. Risk of strike down of pro-competitive rule changes, assessed at zero. If the Commission rejects this assessement, the methodology in Annex 3 implies a detriment	19	to	36	million NPV.				

9.4 In relation to each line item, the Applicant submits as follows:

Lower cost of capital

9.5 The Commission accepted that the higher regulatory risk under the counterfactual would impact on the cost of capital in the electricity industry. However, it applied this analysis to privately owned entities only. The Applicant submits that ownership does not affect the systematic risk of investment and therefore the cost of capital analysis applies to SOEs as well. This increases the NPV of the proposed Arrangement in relation to cost of capital to $28m - $57m. (Refer section 7.4 of the LECG report.)

Comparative advantage of industry decision-making

9.6 LECG attributes a higher benefit to the comparative advantage of industry decision-making than attributed by the Commission. This results from using market value rather than production cost as the basis for calculating dynamic efficiency estimates (refer section 7.5 of the LECG report).

Lower transaction, compliance and lobbying costs

9.7 The Applicant agrees with the Commission's analysis in relation to this point.

Strike down risk from transmission & system operator

9.8 The Applicant submits that the counterfactual creates a greater risk that pro-competitive rules will be struck down by the transmission provider / system operator as these parties will tend to favour uniform standards and processes and a Crown EGB will be unlikely to second guess their recommendations, particularly when grid security issues are involved (refer section 7.1 of the LECG report). The calculation also takes into account the dynamic efficiency point referred to above.

Avoidance of over-investment in transmission

9.9 The Applicant agrees with the Commission's analysis in relation to this point.

Competition in transmission service

9.10 The Applicant submits that there would be a significant loss in operational efficiency associated with the counterfactual (assessed at 8%) due to crowding out of private investment and transmission provider / system operator influence over a Crown EGB in favour of uniform standards and processes (refer section 7.3 of the LECG report).

Competition in service provision

9.11 The Applicant agrees with the Commission's analysis in relation to this point.

Under-investment in transmission

9.12 The Commission assessed the potential detriment arising from under-investment in transmission services at $29m-$54m. In light of the arguments outlined in section 6 above in relation to coalition formation under Part F, LECG assesses the likelihood of under-investment relative to the counterfactual as very low and assigns no detriment to the proposed Arrangement (refer section 7.4 of the LECG report).

Strike-down risk from generator/retailers

9.13 The Commission assessed the potential detriment arising from pro-competitive rule changes by generator/retailers at $33m-$72m. LECG considers that the evidence from NZEM and the strong ongoing regulatory threat mean that this risk is minimal. A detriment of zero is assigned to this factor.

9.14 If the Commission finds that some risk exists, it should take into account ensuing regulatory action that would limit the detriment as set out in Annex 3 of the LECG report. The dynamic efficiency point referred to above also applies here. This results in a figure of $19m - $36m. (Refer section 7.1 and Annex 3 of the LECG report.)

Conclusion on the assessment of public benefits and detriments

9.15 Based on the reassessed benefits and detriments, the Applicant submits that the proposed Arrangement will provide a clear net public benefit and that the Commission should grant the authorisation accordingly.

10. OTHER ISSUES

Future Amendments to Rulebook

10.1 The Applicant requests that the Commission provides some guidance to assist the industry when it is considering the need for subsequent authorisation of future amendments to the Rulebook. The Applicant has formulated the following draft guidelines, which it considers are consistent with Part II of the Commerce Act and the Commission's power to vary authorisations under section 65:

> A proposed amendment to the Rulebook should be referred to the Commission for further authorisation, or as an amendment to the initial authorisation, if the change:
>
> - materially changes the public benefits or public detriments upon which the initial authorisation was granted;
> - materially changes the facts on which the initial authorisation was based, or has a significant impact on the basis of the arrangement as initially authorised; or
> - has an anti-competitive purpose or otherwise breaches section 27 (has the purpose, effect or likely effect of substantially lessening competition), section 29 (is or contains an exclusionary provision), section 30 (price fixing), or section 37 (resale price maintenance).

10.2 The Commission's view would greatly assist the industry as the Rulebook evolves in the future. A statement along these lines in the Commission's final determination would be sufficient in this regard.

Extension of Application

10.3 If the Commission authorises the Arrangement, an opponent of the Rulebook could challenge the proposed voting arrangements under section 27 of the Act based on the Commission's statements in the draft determination, as authorisation of these was no expressly sought in the application. The extent of this risk will be affected by the Commission's final view of the voting arrangements and what (if any) conditions are imposed on the authorisation. However, to protect the industry against this risk, the Applicant seeks to extend its application to cover giving effect to the voting arrangements.

10.4 Given the Applicant's view that the voting arrangements are pro-competitive, this was not a matter for which authorisation was originally sought. The Applicant, however, submits that this extension is of a minor nature given the Commission's attention to voting arrangements in the Draft Determination.

10.5 As with the other parts of the Rulebook for which authorisation has been sought (refer letter to the Commission on behalf of the Applicant dated 5 February 2002), the voting provisions are divided into “primary provisions” and “secondary provisions” (essentially implementation and enforcement provisions which give effect to the primary provisions). Similarly, the Applicant also requests that the authorisation cover any “ancillary provisions” which indirectly give effect to the identified primary and secondary provisions.

Primary Provisions

Rule	**Subject matter**
Part A, section I, rule 4	Changing the rules
Part A, section I, rule 5	The guiding principles
Part A, section II, rule 1.9	Election of directors
Part A, section IV	The rule-making process
Schedule A4	Voting entitlements for electing directors
Schedule A5	Resolutions of members
Schedule A6	Voting entitlements on resolutions
Part C, section I, rule 2	Application of Part C
Part C, section I, rule 4	Changing the introductory rules
Part D, section I, rule 3	Changing rules in this section
Part D, section II, rule 2	Changing the rules in section II
Part D, section II, rule 4	Changing rules 1 - 4
Part D, section III, rule 2	Changing the rules in section III
Part D, section III, rule 4	Changing rules 1 - 4
Part E, rule 1.3	Changing the rules in part E

Part E, rule 1.5	Changing rule 1
Part F, section I, rule 1.5	Changing the rules in section I of Part F
Part F, section II, rule 1.3	Changing the rules in section II of Part F
Part F, section II, rule 3	Establishing voting parties to agree service change
Part F, section II, rule 4	Appeal against a decision regarding a service change
Part F, section III, rule 1.4	Changing the rules in section III of Part F
Part G, section I, rule 4	Changing the rules in part G
Part G, section I, rule 6	Changing the rules in section I
Part H, rule 1.2	Changing the rules in part H
Part H, rule 1.4	Changing the introductory rules
Part I, rule 2	Application of part I

Secondary Provisions

Rule	**Subject matter**
Part A, section I, rule 8	Participants must observe the rules
Part A, section II	The Board
Part A, section V	Supervision
Schedule A3	Working group appointment and procedures

Possible Conditions on Authorisation

10.6 The Commission has jurisdiction under section 61(2) of the Commerce Act to impose conditions on any authorisation granted to the Applicant. The discretion to impose conditions is wide and includes the discretion to make the authorisation conditional on certain terms of the Arrangement being amended as specified by the Commission (*Re New Zealand Kiwifruit Exporters Association (Inc) - New Zealand Kiwifruit Coolstorers Association (Inc)* (1989) 2 NZBLC (Com) 104,485).

10.7 The Applicant is not currently in a position to put forward possible rule-change conditions as there has not been sufficient time to ascertain what changes would be likely to receive the support of the industry. The development of the governance structures reflected in the Rulebook has been the subject of rigorous review by the GWG. Any change to the Rulebook which might be proposed in a condition of the authorisation needs to go through a similar review process to ensure that it would be accepted by the industry and that it does not have unintended consequences for the governance structure. As noted in the introduction, this matter has been referred to the GWG.

10.8 It is intended that this working group will consider some specific proposals to address the Commission's concerns in relation to pro-competitive rule changes and comprehensive coverage. If the GWG agrees that some changes are desirable then those changes will be considered by EGEC on 5 June. If the rule changes are supported by EGEC then it is proposed to offer those rule changes at the conference as possible conditions that the Commission might consider in granting any authorisation.

APPENDIX A: ANSWERS TO COMMISSION'S QUESTIONS

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

The Applicant submits that the Commission has appropriately defined and incorporated the ancillary provisions in its assessment.

2. Are the markets defined by the Commission the appropriate markets for the assessment of the application?

The Applicant agrees with the market definition in the Draft Determination, except that it would not group "other services" as a single market. The Applicant does not, however, believe that anything turns on this distinction.

3. Does the wholesale pricing mechanism in the proposed arrangements breach s 30?

The Applicant submits that the wholesale pricing mechanism does not breach section 30 for the reasons given in Appendix B.

4. Does the transmission pricing methodology in the proposed arrangements breach s 30?

The Applicant submits that the transmission pricing methodology does not breach section 30 for the reasons given in Appendix B.

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

The Applicant submits that the cost allocation provisions do not breach section 30 for the reasons given in Appendix B.

6. Has the Commission correctly applied the provisions of s 30 to the proposed pricing arrangements?

The Applicant submits that the Commission has not correctly applied the provisions of section 30 for the reasons given in Appendix B.

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

The Applicant submits that the most likely alternative scenario is a Crown EGB with *initially* the Guiding Principles in the current GPS (although it could adopt the Industry EGB's Guiding Principles) and operational rules similar to the proposed arrangement. The Applicant submits that the Guiding Principles in the GPS would be subject to change for two reasons:

First, the Crown EGB would come to recognise the practical limitations of the Guiding Principles in the current GPS (as discussed in the LECG Report);

Second, the Guiding Principles are likely to change as the political environment changes. In support of this view is that the Policy Targets Agreement between the Minister of Finance and the Governor of the Reserve Bank is a five-year agreement but has been changed six times in the 12 year period since the first PTA was signed in 1989. The majority of these changes were initiated by the Minister of Finance. The Applicant also notes that the GPS has itself been modified since publication.

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

The Applicant submits that the reverse would be the case, that a change in the GPS Guiding Principles closer to the language of the proposed arrangement would have potential to enhance competition and increase consumer welfare. Section 4 of this submission and section 2 of the LECG Report discusses in detail the reasons for this view.

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

The Applicant submits that the proposed arrangement in fact *increases* the likelihood of pro-competitive rule changes being implemented. The reason is the inherent incentives on the transmission provider and system operator to over-emphasise system security at the expense of competition, with this being a higher risk under the counterfactual. Section 3 of the LECG Report presents a detailed qualitative and quantitative analysis in support of this conclusion.

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

The Applicant submits that the different production processes of the generators and their varied locations on the grid make it difficult to conceive of an efficiency enhancing rule change that would simultaneously disadvantage all existing companies. Furthermore:

- Any rule change that would improve competition would release value. Decision processes in the proposed arrangement are designed to facilitate Pareto improving changes through 'packages' of changes. The proposed arrangement is an example of how multiple changes can be packaged to achieve a range of support;

- The industry processes are open and transparent and are intended to ensure that all proposals are considered on their merits;

- The Government may declare the objectives for the Industry EGB, will negotiate performance standards with the EGB annually under Part XV of the Electricity Act, and two officers of Parliament report annually on progress against those objectives and standards. This provides a mechanism for the Government to apply continued pressure should concern emerge that pro-competitive rules changes were being delayed or blocked.

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

No pro-competitive rule changes put to the vote in NZEM have been voted down (refer Annex 2 of LECG Report).

The Applicant does not submit evidence on MARIA because its voting structure is not comparable to the proposed arrangement . The Applicant does not submit evidence on MACQS because it has not been implemented operationally.

12. What examples are there under NZEM, MACQS and MARIA of pro-competitive rule changes being implemented?

The Applicant submits that 27 pro-competitive rule changes have been implemented in NZEM. Seven pro-competitive rule changes are being processed through NZEM currently. The Applicant does not submit evidence from MARIA and MACQS for the reasons noted in answer to question 11.

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

The Applicant submits that technology advances and other factors over time could make feasible substantial changes to enhance competition. While the industry has been focussing on the development of an integrated Rulebook many rule changes have been put on hold to have a steady "base case". If the authorisation is granted they would go through the rule change process.

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

The Applicant submits that the entire decision-process, including the checks and balances, openness and transparency, is important to efficient decision-making in the long-run interests of consumers. The voting arrangements are one component of the decision-process, albeit an important one.

15. What services would be likely to be provided on a competitive basis under a Crown EGB? How does this situation compare with the proposed arrangements?

The Applicant submits that system operator and possibly market administration services are less likely to be provided on a contestable basis under the Crown EGB than under the proposed arrangement (see LECG Report, section 6).

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

The Applicant agrees that competing trading arrangements (embodying alternative administration, pricing and clearing services) would not be implemented initially under the Crown EGB. Any proposal to include such arrangements would delay considerably the implementation of the new rulebook and this would be contrary to the stated intention of the Minister. Looking ahead, the Applicant submits that that the proposed arrangement has greater potential than the counterfactual to introduce a change of rules to better facilitate competing arrangements if desired by members.

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

The Applicant submits that there is no lessening of competition because the counterfactual would be more likely to impose a single set of arrangements on all participants in the electricity industry.

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

The Applicant submits that the Part C provisions would be adopted under the counterfactual but that the proposed arrangement would be pro-competitive relative to the counterfactual in the application of these provisions. The LECG Report (December 2001, para. 120-122) assessed that the proposed arrangement is more likely than the counterfactual to make full and proper use of the exemptions and dispensations provided under the rules.

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

The Applicant submits that the Part D provisions would be adopted under the counterfactual and that the proposed arrangement would be competitively neutral relative to the counterfactual in the application of these provisions.

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

The Applicant submits that the Part E provisions would be adopted under the counterfactual and that the proposed arrangement would be competitively neutral relative to the counterfactual in the application of these provisions.

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

The Applicant submits that the quality of appointments to an Industry EGB may be higher over time because the appointment process would be less political. The Crown EGB would also be subject to greater Ministerial direction, increasing the risk that its views on pricing methodology may be influenced by social or other considerations. In support of this argument, the Applicant notes the requirements in the GPS concerning the proportion of fixed charges in a householder's invoice.

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

The Applicant submits that an industry EGB is likely to be more effective over time in removing any existing pricing inefficiencies because it would be less subject to political direction.

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

The Applicant agrees with paragraph 320 of the Draft Determination. The Applicant submits that the Commission's assessment (para. 321) relating to the proposal's reliance on Quantum Meruit to enforce charges is not correct and refers to section 6.12 of this submission. The transmission provider does not bear the credit risk in relation to non-members and members are under contractual obligation to pay under Part F (see section 4.7.3 of the LECG Report).

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

The Applicant agrees with the Commission's assessment that over-investment in transmission services would occur under the counterfactual. The Applicant does not agree with the Commission's assessment that transmission under-investment would occur in the proposed arrangement. The Applicant submits that the Commission's view is premised on a misunderstanding about the decision-processes in Part F of the proposed arrangement. Additionally, the Applicant submits that the use of regulatory force under the counterfactual to mandate transmission investments would likely have adverse impacts on other industry participants. In particular, there is significant risk that investment by competitor and substitute suppliers will be crowded out.

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

The Applicant submits that a Crown EGB is likely to be subject to greater Ministerial direction, increasing the risk that its views on pricing methodology may be influenced by social or other considerations to a greater extent than an Industry EGB.

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

The Applicant submits that the Part G provisions would be adopted under the counterfactual and that the proposed arrangement would be competitively neutral relative to the counterfactual in the application of these provisions.

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

The Applicant submits that the Part H provisions would be adopted under the counterfactual and that the proposed arrangement would be competitively neutral relative to the counterfactual in the application of these provisions.

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

The Applicant submits that the Part I provisions would be adopted under the counterfactual and that the proposed arrangement would be competitively neutral relative to the counterfactual in the application of these provisions.

28. Notwithstanding the Commission's usual approach of not counting transfers of wealth between one group and another either as a benefit or detriment, having

regard to the principles of the GPS which emphasise the wellbeing of consumers, is there a case in this instance for recognising transfers from consumers to producers in this assessment of detriments? If so, what weight should be given to this factor when assessing detriments against benefits?

The Applicant submits that transfers, if any, from consumers to producers should not be included in the assessment of detriments. The Applicant notes that proposed arrangement would not prevent Government from making wealth transfers if it so desires.

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

The Applicant notes that development of the proposed arrangement has been influenced by the GPS. It is clear that the proposed arrangement was initiated as a direct result of the GPS.

Looking ahead, the Applicant agrees with the Commission's assessment that the influence of the GPS on the Industry EGB would be less strong relative to the Crown EGB. The proposed arrangement has the advantage that the Industry EGB will be in the position of ensuring any tensions between industry parties and the policy objectives of the Government of the day are managed constructively. The EAA provides a mechanism for the Government to apply continued pressure by declaring objectives for the Industry EGB and two officers of Parliament to report annually on progress against those objectives.

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

The Applicant submits that, to the extent tensions arise, the proposed arrangement provides a better process, including checks and balances under the Commerce Act, to ensure the impact is a net benefit relative to the counterfactual. The concentration of decision-making authority under the counterfactual, with such decisions outside the jurisdiction of the Commission, is likely to result in some decisions being welfare-reducing.

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

The Applicant agrees with the Commission's assessment that the Crown EGB would possess less competence than the industry in assessing the effects of rule changes. However, in terms of decision rights under the counterfactual in relation to regulations, the Applicant submits that the focus should be on the Minister rather than the Crown EGB. This widens further the gap between the proposed arrangement and counterfactual.

The Applicant submits also that the Commission has not taken into account the incentives on the transmission provider and system operator and how this exacerbates the risk of over-emphasis on security issues at the expense of competition and overall efficiency under the counterfactual (see Section 3 of the LECG Report).

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

The Applicant submits that the proposed arrangement would have no material impact on other markets.

33. Would the cost of capital be different in the proposed arrangements relative to the counterfactual?

The Applicant submits that the cost of capital would be higher under the counterfactual due to increased regulatory risk.

34. Would regulatory risk affect only the cost of capital for private sector interests or would it also affect the cost of capital for SOEs?

The Applicant submits that regulatory risk would affect the cost of capital of both private sector entities and SOEs in the electricity market. Section 7.4 of the LECG Report refers to a handbook prepared for The Treasury which provides no indication that the estimate of beta (the measure of systematic risk) for an SOE is affected by its ownership.

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

The Applicant submits that the weight given in the Draft Determination to the potential effects of a Crown EGB on productive and dynamic efficiency is appropriate.

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

The Applicant submits that the Crown EGB is disadvantaged in deciding on rule changes because of the:

- Information brought to bear.
- Competencies of the decision-makers at each stage in the process.
- Way in which conflicting views and interests are resolved.

The industry process provides countervailing tensions to any incentives to block pro-competitive rules. The Crown EGB however would encourage potentially welfare reducing behaviour in terms of the trade-offs between customer costs (reduced through competition) and system security.

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

The Applicant submits that allocation efficiency in the wholesale market would be reduced under the counterfactual through reduced competitive pressure as the Crown EGB and Minister would give greater weight to security concerns expressed by the transmission provider and system operator.

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

The Applicant submits that lobbying costs would be higher under the counterfactual but has not undertaken independent estimates.

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

The Applicant submits that the counterfactual would result in over-investment in the grid. We note that Transpower expressed a consistent view in its letter (18 June 1999) and submission on the Commerce (Controlled Goods or Services) Amendment Bill.

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

The Applicant submits that industry input would provide little effective restraint on the potential for over-investment and over-maintenance. The Crown EGB and Minister have an incentive to err on the side of security while bearing few of the costs of investment. The Applicant submits that 'consultation' would not be effective in the same way that allocation of decision rights to industry parties would be.

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

The Applicant submits that the likelihood of system operator services being contestable under the proposed arrangement is higher than in the counterfactual. The LECG Report (December 2001) assessed the probability at 75 percent.

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

The Applicant does not have available evidence on the magnitude of benefits available from making services contestable that would be comparable to service provision in the electricity industry.

43. Is the Commission's assessment that under a Crown EGB if services were made contestable, it would also allow competitive bypass of service providers correct? If so, would the efficiency gains from that additional competition have a material impact on net benefits?

The Applicant submits that holding contestable tenders for defined service provider roles would not itself allow competitive bypass. The latter depends on the rules and provisions for exemptions from the rules rather than whether a particular service is made contestable.

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

The Applicant submits that there is likely to be significant scope to evolve the rules as new technology develops and becomes commercially viable and other opportunities arise.

45. What are the incentives on distributors to vote on reduction or elimination of grid constraints?

The Applicant submits that distributors would vote for reduction or elimination of grid constraints to the extent that such investments would increase their potential revenue earning ability.

46. Are distributors likely to have different attitudes to elimination of transmission constraints that have security implications and transmission constraints that lead to higher energy prices?

The Applicant submits that the incentives on distributors are stronger in the case of security of supply issues. Distributors have a weak but positive incentive to favour reduction in congestion constraints because lower prices for delivered electricity would stimulate demand for network capacity.

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

The Applicant submits that there is no detriment because the Commission's view on transmission under-investment appears to be premised on a misunderstanding of vote allocation under Part F. Section 4 of the LECG Report discusses the issues in detail.

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

The Applicant submits that no detriment occurs for the reasons given in response to Question 47 and because strike down of pro-competitive rule changes is more likely under the counterfactual than the proposed arrangement.

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

The Applicant submits that the issues outlined by the Commission provide a reasonable summary of the relevant issues which should be considered.

50. If the Commission chose to authorise the proposed arrangements, what condition(s) on the authorisation would address concerns about the potential for pro-competitive rule changes not being implemented and any negative downstream effects?

The Applicant is not in a position to propose conditions at this stage. However, possible rule changes, which may potentially be proposed as conditions upon which the authorisation might be granted, have been referred to the Governance Working Group.

51. What would be the benefits and detriments arising from such a condition(s)? Would the imposition of such a condition(s) be consistent with the Act?

See above.

52. Are there any other matters which the Commission could appropriately address with conditions to an authorisation?

The Applicant is not aware of any such matters.

53. Is it appropriate to use a ten year time horizon for the purpose of calculating benefits and detriments?

The Applicant submits that a 10 year time horizon is the minimum period appropriate for calculating the benefits and detriments. (See also answer to question 59).

54. Are the Commission's assumptions on the magnitude of efficiency gains arising from the comparative advantage of industry arrangements relative to the counterfactual appropriate?

The Applicant submits that the magnitude of efficiency gains is higher than estimated in the Draft Determination. As set out in section 7.5 of the LECG Report, the calculation of dynamic efficiency should be based on the market value of output rather than production cost.

55. Are the Commission's estimates of the higher transactions costs in the counterfactual of an appropriate order of magnitude?

The Applicant submits that the Commission's estimates probably under-estimate the transactions costs under the counterfactual. However, the LECG Report does not provide an alternative estimate.

56. Are the Commission's assumptions on the potential range of efficiency losses in the counterfactual of an appropriate order of magnitude?

The Applicant submits that the Commission over-states the extent to which gains in operational efficiency would be achieved under the counterfactual, hence under-states the relative benefit under the proposed arrangement. Section 5 of the LECG Report suggests that the use of regulatory force to mandate investments by Transpower under the counterfactual would crowd out competing and substitute services. Hence, rivalry and competitive pressure potentially would be reduced significantly under the counterfactual relative to the proposed arrangement.

57. The Commission invites comment on its assessment of the magnitude of efficiency losses in the counterfactual relative to the proposed arrangements.

The Applicant submits that poor performance by service providers has the potential to increase compliance and other resource costs in the electricity and transmission markets. It has not estimated the potential magnitude of these impacts.

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

The Applicant submits that the likelihood of system operator services being contestable under the proposed arrangement is higher than in the counterfactual. The LECG Report (December 2001) assessed the probability at 75 percent.

59. The Commission invites comment on its assessment of the potential for price increases, relative to the counterfactual.

The Applicant submits that the proposed arrangement is pro-competitive relative to the counterfactual, implying a price *decline* under the proposed arrangement relative to the counterfactual. The LECG Report adopts the Commission's assumptions on the magnitude of price effects, but reverses the sign.

To the extent that the Commission does not accept that the proposed arrangement necessarily would be pro-competitive relative to the counterfactual, the Applicant submits that any adverse price effect would be curtailed within two years by the Minister taking a strong stance on competition issues. Annex 3 of the LECG Report presents a framework for calculations under this scenario.

60. Are the assumptions on long-run supply and demand elasticities appropriate?

The Applicant submits that the elasticities assumed in the Draft Determination are appropriate.

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

The LECG Report of December 2001 modelled the effects of dry winters. The Applicant makes no further submission on the issue.

62. Is the Commission's assessment of the magnitude of potential efficiency losses arising from a reduction in competitive pressure appropriate?

The Applicant submits that the proposed arrangement is pro-competitive relative to the counterfactual, implying an efficiency *gain* under the proposed arrangement relative to the counterfactual. The Applicant notes that the LECG Report adopts the Commission's assumptions on the magnitudes but reverses the sign and incorporates the 'market value' base as noted under Question 54.

63. Is the Commission's assessment of the likelihood of under-investment in transmission under the proposed arrangements, relative to the counterfactual, appropriate?

The Applicant submits that under-investment in transmission is unlikely under the proposed arrangement relative to the counterfactual. Section 4 of the LECG Report suggests that the use of regulatory force under the counterfactual is likely to crowd out investment by suppliers of potentially competing and substitute services to transmission.

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

The Applicant makes no submission of this issue as it believes that transmission under-investment is unlikely under the proposed arrangement.

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

The Applicant makes no submission of this issue as it believes that transmission under-investment is unlikely under the proposed arrangement.

APPENDIX B: LEGAL ISSUES

1. INTRODUCTION

1.1 This submission relates to paragraphs 106 to 148 of the Commission's Draft Determination in relation to section 30 of the Commerce Act 1986 (**"Act"**).

2. SUMMARY OF DRAFT DETERMINATION

2.1 The Draft Determination identified the following issues:

(a) the wholesale pricing mechanism may create "some constraints upon the free action of the generators and wholesalers in determining the final price for electricity and reserves" (paragraph 130 of the Draft Determination) and therefore may breach section 30;

(b) the arrangement for charging non-members for Rulebook services breaches section 30 (paragraph 137 of the Draft Determination);

(c) the "effect of Part F, section III is to obtain some agreement on a pricing methodology, and thus provides for a large degree of control over final prices" in breach of section 30 (paragraph 142 of the Draft Determination); and

(d) provisions "relating to the quality of electricity and the way these costs are allocated have an impact on the final price of electricity" in breach of section 30 (paragraph 144 of the Draft Determination).

3. SUMMARY OF THE APPLICANT'S SUBMISSIONS

3.1 In summary, the Applicant submits that:

(a) the Commission is correct in its conclusion that the arrangements for charging non-members for Rulebook services falls within the ambit of section 30;

(b) the Commission has extracted certain principles from the recent decisions on price fixing and section 30 (*Commerce Commission v Taylor Preston Ltd* [1998] 3 NZLR 498 (HC), *Commerce Commission v Caltex New Zealand Ltd*

(1999) TCLR 305 (HC) and *Australian Competition and Consumer Commission v CC (NSW) Pty Ltd* (1999) ATPR 41-732 (FC)). The principles extracted reflect a broader approach than intended by the courts in these decisions;

(c) section 30 was not intended to extend to arrangements which merely provide a process for allowing a price to be set in response to changes in supply and demand. A rule to *find*, rather than *fix,* a price is non-infringing;

(d) the effect of the Commission's interpretation of section 30 is to make many common and efficient business practices *per se* illegal - including trading exchanges, auctions and tender processes; and

(e) in applying a correct (and narrower) approach to the section, the following aspects of the Arrangement do not breach section 30:

(i) wholesale pricing mechanisms;

(ii) process for determining a transmission pricing methodology; and

(iii) allocation of common quality costs and the costs for the pricing and reconciliation manager.

4. BACKGROUND TO SECTION 30

The intended scope of section 30

4.1 The aim of section 30 is to prohibit collective pricing practices which are contrary to the public interest due to the detrimental effects of these practices on the prices of goods and services in a market. In particular, Parliament enacted section 30 to prevent price fixing cartels interfering with the setting of prices for goods and services in an otherwise dynamic market. The classic example of the kind of conduct which was intended to be prohibited is where competitors enter into horizontal price fixing arrangements to artificially raise prices.

4.2 It is submitted that the Commission's approach in the Draft Determination extends section 30 in two ways not intended by Parliament:

(a) Parliament did not intend section 30 to extend to arrangements which merely provide a process for allowing a price to be set in response to changes in supply and demand. A sophisticated commodity - such as electricity, futures

or equities - can only be traded in a sophisticated market which has imported certain trading rules; section 30 was not intended to prevent the formation of such a market. A rule to *find*, rather than *fix,* a price is non-infringing.

(b) Parliament did not intend section 30 to extend to arrangements where competitors share a common input.

4.3 If this approach is followed in the final determination, it could have the effect of making many common and efficient business practices *per se* illegal. Examples include:

(a) commodity, security and futures exchanges;

(b) auction mechanisms;

(c) tender processes;

(d) the sharing of costs of facilities which are jointly acquired by competitors, such as a common delivery van for two takeaway outlets, carparks shared by two law firms and industry fora with costs spread between the participants;

(e) body corporate agreements where some of the members are competitors; and

(f) a vertically integrated company which owns a bottleneck facility and sells access to other competitors to allow competition in the downstream market.

A narrow approach should be preferred to a broad approach

4.4 The Applicant submits that in resolving any ambiguity in relation to section 30, a narrow approach to the section should be favoured over a broader approach:

(a) A broad approach runs the risk of deeming harmless or even efficiency enhancing conduct, of the type referred to above, to be illegal. A broad approach to section 30 could result in such practices being deemed to be *per se* illegal which must be contrary to Parliament's intention.

(b) Conversely, a narrow approach to section 30 does not share the same kind of downside. A provision which does not come within the ambit of section 30 is still subject to the constraints imposed by section 27 (contracts, arrangements, or understandings substantially lessening competition), and the remainder of Part II of the Act.

4.5 Therefore, a narrow approach to section 30 is likely to be more consistent with the purpose and scheme of the Act than a broad interpretation of the section.

5. THE CORRECT TEST: *INSURANCE COUNCIL*

5.1 The Applicant submits that the correct approach to section 30 can be found in the following statement of principle in *Insurance Council of New Zealand (Inc) Decision 236* (1989) 2 NZBLC (Com) 99-522 (at 104,482):

> 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".
>
> [emphasis added]

5.2 The Commission referred to the judgment of Lockhart J in *Radio 2UE Sydney Pty Ltd v Stereo FM Pty Ltd* (1982) 4 ATPR 43,912. The following passage (at 43,920) has been the source of some judicial comment since:

> **It is important to distinguish between arrangements** (I use this expression for convenience to encompass also contracts and undertakings) **which restrain price competition and arrangements which merely incidentally affect it or have some connexion with it. Not every arrangement between competitors which has some possible impact on price is per se unlawful** under that section.
>
> Nor in my view was s.[30] introduced by Parliament to make arrangements unlawful which affect price by improving competition ….
>
> If competition is improved by an arrangement I cannot perceive how it could be characterized as a price fixing arrangement within the ambit of those sections …
>
> **If competitors make an arrangement to establish a better market by, for example, forming an organisation through which they operate by exchanging information in ways that make prices more competitive, I do not see how such an arrangement is, per se, prohibited by s.[30].**
>
> [emphasis added]

5.3 This general approach was also affirmed by the full Federal Court in *Radio 2UE Sydney Pty Ltd v Stereo FM Pty Ltd* (1983) 5 ATPR 44,398 which stated that "[t]here must, we believe, be an element of intention or likelihood to affect price competition before price "fixing" can be established" (at 44,401).

5.4 The particular comment which has been scrutinised since is the third passage quoted above, that "[i]f competition is improved by an arrangement I cannot perceive how it

could be characterized as a price fixing arrangement within the ambit of those sections." It is submitted that there are two possible interpretations of this statement:

(a) The "pro-competitive defence" interpretation (which has been advanced in some later cases) is that a breach of section 30 can be excused if the defendant can show that the conduct in fact enhanced competition. Such a statement is clearly wrong at law - as has been made clear in *Taylor Preston* and *Caltex New Zealand* (see below). It seems unlikely that this could have been the interpretation that the Judge intended.

(b) The second interpretation is that by "competition" he really meant "the price finding process". That is, as is evidenced by the example he gives of an information exchange later in the passage, Lockhart J simply meant "[i]f [the price finding process] is improved by an arrangement I cannot perceive how it could be characterized as a price fixing arrangement within the ambit of those sections." This is also consistent with the facts of the case which concerned a combined rate card which, on a small scale, is a price finding process.

5.5 The key point is not which meaning Lockhart J had in mind. Rather, the Applicant submits that where doubts have been cast on the correctness of his statement, the first meaning has been adopted. The second interpretation and the related comments in the rest of his judgment have not been questioned. *Radio 2UE* therefore still stands for the proposition that price competition must be restrained in order for section 30 to be breached and that arrangements which "make prices more competitive" in the sense of being better price finding processes do not breach section 30.

5.6 The Commission in *Insurance Council* correctly distinguishes between interfering with the setting of a price (which is prohibited per se), as opposed to allowing the price to be set by changes in supply and demand in the market (which is not a price fixing arrangement). A process which creates orderly processes to enable buyers and sellers to form a market does not fix, control or maintain a price.

5.7 In this regard, the Applicant refers to the observations of Ronald Coase in *The Firm, the Market and the Law* (at p9):

> All exchanges regulate in great detail the activities of those who trade in these markets (the times at which transactions can be made, what can be traded, the responsibilities of the parties, the terms of settlement, etc.), and they all provide machinery for the settlement of disputes and impose sanctions against those who infringe the rules of the exchange. It is not without significance that these exchanges, often used by economists as examples of a perfect market and perfect competition, are markets in which transactions are highly regulated (and

> this is quite apart from any government regulation that there may be). It suggests, I think correctly, that for anything approaching perfect competition to exist, an intricate system of rules and regulations would normally be needed.

5.8 The ironic result is that notwithstanding Professor Coase's praise of sophisticated self-regulating markets as models of perfect competition, the Commission's approach produces the real risk that such markets will per se infringe the Act - so that any significant self-regulating market will need either authorisation or establishment pursuant to legislation.

5.9 The Applicant submits that the approach taken by the Commission in *Insurance Council* is entirely consistent with the recent decisions in *Taylor Preston*, *Caltex New Zealand* and *CC (NSW) Pty*. The Commission, in the Draft Determination, has incorrectly assessed the relationship between *Insurance Council* and the subsequent decisions in *Taylor Preston*, *Caltex New Zealand* and *CC (NSW) Pty*. Instead the decision in *Decision No. 280 Electricity Market Company Limited* (13 September 1996) ("NZEM"), which is also consistent with these recent decisions, should be applied to the present application.

Taylor Preston

5.10 In *Taylor Preston*, the defendants were accused of entering into a price fixing arrangement in relation to the setting of prices in the livestock market. The behaviour challenged related to price-fixing activity within an existing market, and did not involve price finding processes. Fisher J stated that (at page 509):

> The result is that *once a price-fixing provision has been established* it is to be conclusively assumed that it is inherently anti-competitive. It will not be open to a defendant to submit, or to call expert evidence to suggest, the contrary.
>
> [emphasis added]

5.11 The Applicant does not dispute the validity of this proposition, nor the intent of Parliament to enact a per se rule, which applies "*once a price fixing provision has been established*". However the existence of an interference with competitive supply and demand remains a *threshold requirement* for section 30 to apply at all.

Caltex New Zealand

5.12 In *Caltex New Zealand*, the defendants (who were three major oil companies) were accused of entering into a price fixing agreement whereby the parties agreed to simultaneously withdraw their free or discounted car washing services. Salmon J

endorsed *Taylor Preston* and further commented, on the existence of a pro-competition defence, that (at page 311):

> An arrangement or understanding which comes within the terms of subs. (1) [once a price fixing arrangement has been established] is deemed to have the purpose or have or to be likely to have the effect of substantially lessening competition in a market. Whether in fact it has that effect is irrelevant.

Salmon J also quoted an earlier statement of Elias J in the striking-out application ([1998] 2 NZLR 78, 84):

> If the Commission is right as a matter of fact that the promotion was an integral part of the price of petrol or of car washes, then an agreement to remove it is an agreement to raise prices to the extent of the former discount. A new level of price will have been established. Whether or not the companies differentiate their prices on some other basis does not affect the result.

According to Salmon J, a defendant cannot rely on a "pro-competition" defence to exclude liability under the section *once a price fixing arrangement has been established*.

5.13 The Applicant submits that this proposition is correct and remains entirely consistent with the earlier approach taken by the Commission in *Insurance Council*. In *Caltex New Zealand*, it was not necessary to establish a fixed price or agreed discount to come within the ambit of section 30. However, the section still requires an anti-competitive arrangement - ie one which fixes , controls or maintains prices (most likely by raising or preserving those prices) which would otherwise be freely arrived at in a market without collusion between competitors. This is consistent with the proposition from *Insurance Council* that an *interference* with the setting of a price amounts to a price fixing arrangement.

5.14 The Commission, in the Draft Determination, has implied that Salmon J's definition of "control" (to "exercise restraint or direction upon the free action of") is inconsistent with *Insurance Council* and the *NZEM* decision. However, the term "control" should not be read in isolation, but in context. The section requires the "fixing, controlling or maintaining, a price for goods or services". The Applicant submits that “restraint” entails some limitation on the substance of what parties in a market would bid and agree. If the agreement only *facilitates their reaching* such an agreement, and does not interfere with normal market behaviour, it cannot involve a section 30 infringement. Both *CC (NSW) Pty* (discussed below) and *Caltex* involved an agreement that interfered with the substance of the economic exchange achieved.

CC (NSW) Pty

5.15 In *CC (NSW) Pty*, the defendants entered into an agreement whereby the parties, when tendering for a construction project, agreed to make payments to the unsuccessful tenders and to take such payments into account in the preparation of tenders Although the possibility of a "pro-competition" defence was dismissed as being inconsistent with the per se nature of section 45A (the equivalent of section 30), Lindgren J held that (at 43,513):

> An agreement, arrangement or understanding that has the effect of fixing, maintaining or controlling price **will have some effect on price competition**, although not necessarily the effect of eliminating or even substantially lessening it. The effect of controlling price, even without a substantial lessening of price competition, can form the foundation of a deemed contravention of s 45 of the Act.
>
> [emphasis added]

5.16 *CC (NSW) Pty* therefore supports the proposition that a provision must have "some effect on price competition" before a price fixing arrangement can be established. The Applicant submits that the test in *CC (NSW) Pty* is consistent with the approach taken by the Commission in *Insurance Council*. That is, a provision which allows a price to be set according to changes in supply and demand (*Insurance Council*) does not have the requisite effect on price competition (*CC (NSW) Pty*) and is, therefore, not a price fixing arrangement to begin with. On the other hand, an arrangement which interferes with the setting of prices by the market is clearly having "some effect on price competition" and is, therefore, a price fixing arrangement under section 30.

Summary

5.17 It is submitted that the approach in *NZEM* and *Insurance Council* is consistent with the subsequent case law. That is, they still capture arrangements where parties have attempted to fix prices in the livestock market (for example in *Taylor Preston*), where there has been an attempt to simultaneously withdraw a free or discounted service (as in *Caltex New Zealand*) or where parties have agreed to make secret payments to unsuccessful tenders (as in *CC (NSW) Pty*).

5.18 All market-driven price determination processes - such as auctions, exchanges and tender processes - create a set of rules, protocols and formulae which, in a sense, restrain how the participants may act. Some such set procedures must be created in order for market prices to be determined at all. However, they do not "interfere" with the price determination process, and are not “per se” caught by section 30. That must be consistent with the intent of Parliament.

6. ASSESSMENT OF COMMISSION'S PRINCIPLES

6.1 The Commission, in the Draft Determination, has based its conclusions on the following principles:

(a) the competitive effect of a provision is irrelevant when determining a price fixing arrangement (see paragraphs 111, 112 and 129 of the Draft Determination);

(b) a provision does not need to control price in a "competition sense" to constitute a price fixing arrangement (see paragraphs 121, 122 and 123 of the Draft Determination); and

(c) the term "control" means to exercise restraint or direction upon the free action of (see paragraphs 122, 124 and 129 of the Draft Determination).

6.2 As to (a) the Commission has stated that, "the competitive effect of a provision is irrelevant when considering whether it falls within s 30" (paragraph 129 of the Draft Determination). The Applicant submits that this proposition does not accurately reflect the current approach adopted by the courts in New Zealand and Australia. Once a price fixing arrangement has been established it is deemed to have the purpose, like effect, or actual effect of substantially lessening competition. However, when determining whether a price fixing arrangement has been established, the Commission must assess as a threshold requirement whether the provision is interfering with the substantive setting of a price by the market (which is prohibited and illegal *per se*), or whether the provision is simply allowing the price to be set according to the market.

6.3 As to (b) the proposition that a provision does not need to affect price in a "competition sense" to constitute a price fixing arrangement is incorrect. Although there is no "pro-competition" defence to section 30, in assessing whether price fixing is present at all, the Commission is required to determine whether the provision affects price in a competitive sense by interfering with a price being set according to normal market forces of supply and demand.

6.4 As to (c) it should be noted that the definition of "control" referred to in *Caltex New Zealand* is simply a partial re-statement of a much earlier definition proposed in *TPC v Ansett Transport Industries (Operations) Pty Ltd* (1978) ATPR 40,071 ("to exercise restraint or direction upon the free action of; to hold sway over, exercise power or act authority over; to dominate or command"). This definition of "control" does not require a

departure from the approach taken by the Commission in *Insurance Council* and an overly literal attempt to do so is inconsistent with the purpose of the Act and with common sense.

7. WHOLESALE PRICING MECHANISMS

7.1 The Applicant submits that none of the cases referred to by the Commission in the Draft Determination change the law as stated in *Insurance Council* and applied in *Decision 280* that price fixing requires "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".

7.2 The wholesale pricing provisions do not "interfere" with the setting of electricity prices. The wholesale pricing mechanism allows the price of electricity to be determined in response to the supply and demand for electricity. Similarly, applying the test from *CC (NSW) Pty*, there is no effect on price competition.

7.3 The Applicant refers to its description of the wholesale pricing mechanism in paragraphs 24.3 to 24.8 of the original Application and to the competition analysis in paragraphs 24.15 to 24.20 and submits that the Commission should:

(a) affirm the *NZEM Decision* and find that the wholesale pricing provisions do not breach section 30; and

(b) find that section 27 is not breached on the basis that the same regime would apply under the counterfactual.

8. COMMON COST ALLOCATION

8.1 Competitors may agree to share costs in a number of different ways. Common examples include:

(a) Competitors may share the cost of a jointly owned asset. This could occur, for example, where two competing takeaway outlets share the use of a delivery vehicle.

(b) Competitors may share the costs for the establishment and operation of an industry forum or the setting of common processes or standards such as customer switching protocols.

(c) Competitors may also indirectly share the cost of an asset where a vertically integrated company which owns a bottleneck facility grants access to other competitors to allow downstream competition.

8.2 In its Draft Determination, the Commission applied the test from the *Decision 369 Transpower New Zealand Limited* (13 August 1999) ("*MACQS Decision*"), namely, that "the allocation of costs of a service which the parties acquire in competition with one another and where the costs will necessarily impact directly on final prices" will infringe section 30. The Commission then added that the last part of this test, that is the qualification that the costs must impact directly on final prices, is inconsistent with both *Caltex New Zealand* and *CC (NSW) Pty*.

8.3 In practice, therefore, the test appears to be that any allocation of costs between competitors in relation to a service for which they compete breaches section 30. The kinds of costs which are shared under the Rulebook are analogous both to industry forum costs (eg governance overheads) and the co-owned delivery vehicle (common quality). It would therefore appear that the Commission's test could conceivably make cost allocations between competitors, which are commonplace and can well be efficiency-enhancing, per se illegal.

8.4 The same interpretation of section 30 would also seem to capture the situation where the vertically integrated owner of a bottleneck facility makes it available to another party to enable competition in the downstream market. That is, there would be an agreement between parties who compete in the acquisition and/or resupply of the bottleneck service and the terms of the agreement would affect the price of the service in the downstream market. Such a rule could put a party with significant market power in relation to a bottleneck service in a position where it could (1) breach section 36 by not providing access and yet (2) breach section 30 by providing access. The applicant notes that the original MACQS test (unmodified by *Caltex New Zealand* and *CC (NSW) Pty*) could still make the terms of access to the bottleneck illegal assuming it represented a non-trivial component of the price of the service in the downstream market.

8.5 The Applicant invites the Commission to clarify its position in relation to cost sharing by competitors. The Applicant submits that given the difficulty of determining whether cost sharing is harmful or beneficial, the *MACQS* test should be abandoned in favour of the *Insurance Council* test.

8.6 The Applicant refers to its description of the common cost allocations in paragraphs 28.1 to 28.11 of the original Application and to the competition analysis in paragraphs 28.12 to 28.22 and submits that:

(a) Cost sharing by competitors should not be per se illegal under section 30 unless it interferes with the normal forces of supply and demand in the market for the good or service in the market in which the companies compete (*Insurance Council*). It is submitted that none of the cost sharing in the proposed Arrangement has such an effect; and in the alternative

(b) If the Commission finds that section 30 does apply, 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; and

(c) section 27 is not breached on the basis that the same regime would apply under the counterfactual.

9. TRANSMISSION PRICING

9.1 The Commission, in the Draft Determination, has commented that:

(a) there is a "contract, arrangement or understanding" as to the process the transmission provider must undertake in relation to determining a pricing methodology;

(b) the development of a pricing methodology is not merely a consultative process; and

(c) the effect of Part F, section III is to obtain some agreement on a pricing methodology, and thus provides for a large degree of control over final prices.

9.2 Part F, section III of the Rulebook contains principles and objectives which a transmission pricing methodology must be consistent with, a process for confirming a pricing methodology and an audit process to ensure that an agreed pricing methodology is complied with by the transmission provider. The Rulebook does not set the actual price to be charged by the transmission provider, nor does it state the particular pricing methodology which must be adopted by the transmission provider.

9.3 As discussed above, in relation to the wholesale pricing mechanisms, the rule from *Insurance Council* and *CC (NSW) Pty* is that in order for a provision to be a price fixing arrangement it must have "some effect on price competition" in the sense that in "interferes" with the normal forces of supply and demand.

9.4 It is submitted that:

(a) The transmission pricing methodology does not determine the price set by the transmission provider. Rather it determines how this is allocated by the parties who benefit from the transmission service. The transmission pricing methodology is therefore simply a cost allocation mechanism and is unobjectionable for the reasons specified in section 8 above; and

(b) The process for adopting a transmission pricing methodology is one step removed from the methodology itself. It contains certain principles which the ultimate pricing methodology should comply with.

9.5 The Applicant submits that the process for adopting a transmission pricing methodology does not interfere with the setting of electricity prices which remain to be set by the market through the forces of supply and demand. Therefore, the process whereby transmission pricing methodology is adopted does not affect price competition in the sense required by *Insurance Council* and *CC (NSW) Pty*.

9.6 The Applicant refers to its description of the process for adopting a transmission pricing methodology in paragraphs 24.10 to 24.12 of the original Application and to the competition analysis in paragraphs 24.25 to 24.27 and submits that the Commission should:

(a) find that section 30 is not breached on the basis that these provisions merely provide a process by which a cost allocation mechanism will be determined and that this process does not interfere with the normal forces of supply and demand; and in the alternative

(b) if the Commission finds that section 30 does apply, find that the joint buying exception in section 33 of the Act applies as the affected members are acting collectively in acquiring transmission services; and

(c) find that section 27 is not breached on the basis that the same regime would apply under the counterfactual.