

Meeting #23

2 September 2020

Market
Development
Advisory Group

Agenda items

1. Administration

2. Outcome of Evaluations Panels:

- Debrief on Panel ADB
- Comparison of findings and approach of the two panels
- Key learnings

3. MDAG's view on MDAG proposal

4. Next steps:

- Draft Recommendations paper
- Timeline
- Next meeting

Outcome of Evaluation Panels

Note: These slides have been prepared for the purpose of updating the Market Development Advisory Group. Content should not be interpreted as representing the views or policy of the Electricity Authority.

De-brief on Panel ADB views

Members of Panel ADB

- Hon **Raynor Asher** QC, former Judge of the Court of the Appeal
- Dr **Alan Bollard**, Chairperson of the Infrastructure Commission; former Governor of the Reserve Bank and Secretary of the Treasury
- **Pat Duignan**, Former member of the Commerce Commission; Finance and Economics Expert Lay Member of the High Court

Panel ABD's key observations

[The following four slides are extracted from the "Finding and Conclusions of Evaluation Panel ABD"]

Overall -- the existing Code is unsatisfactory because the core test has no recognised meaning in law, and the safe harbours may protect poor conduct from sanction.

Interpretation of 'high standard of trading conduct' (clause 13.5A(1)):

- A 'reasonable standard of trading conduct' may be easier to interpret than a 'high standard of trading conduct'. This is because the law has a test of what a reasonable person would do, which judges understand. However, 'reasonable' is arguably a lower standard than 'high'.
- A 'high' standard of trading conduct may mean that a generator must always strive to avoid making excessive profits through its trading conduct. A reasonable standard of trading conduct may allow a modest increase in profit for a reasonable amount of time.
- A judge could get an expert opinion on what is considered a 'high standard of trading conduct' in the electricity market – although opinions are likely to differ among experts.
- A Court could possibly consider a high standard of trading conduct to be judged relative to the behaviour which is expected when competition applies, i.e. you are disobeying your natural monopolistic inclination to profiteer. The purpose statement in the Act would tend to support this interpretation – although it is not determinative. That said, a judge is unlikely to find that a generator has exhibited a high standard of trading conduct if it has made profits which are excessive and detrimental to consumers.

Application of safe harbour (clause 13.5B):

- Does ‘offers in respect of all its generating capacity that is able to operate’ (clause 13.5B(1)(a)) mean that the generator can only offer plant that will be available (that is, what happens if a generator offers capacity that they know won’t be available)?
- It is unclear what ‘generally consistent’ means in ‘offers are generally consistent with offers it has made when it has not been pivotal’ (clause 13.5B(1)(c)(ii)). In addition, if a generator is always pivotal then it is impossible to assess whether its offer is generally consistent with offers it has made when it has not been pivotal—this seems to be a deficiency in the existing Code.
- The measurement of financial benefit in ‘does not benefit financially from an increase in the final price at which electricity is supplied in a trading period at a node at which the generator is pivotal’ (clause 13.5B(1)(c)(iii)) could be in any trading period in which the generator is pivotal (ie, the benefit could be gained in a trading period(s) other than the trading period(s) for which the offer(s) were made). This clause of the Code is not clear. There is uncertainty whether, when a generator changes their offer price and thereby prevents the market price from falling when it otherwise would have fallen (eg, due to a constraint on export occurring) but the final price does not increase from the previous period, that meets the criteria that they “benefit financially from an increase in the final price at which electricity is supplied”.
- If a generator or ancillary service provider doesn’t meet (a) and (b) of the safe harbour, then it’s likely to be difficult to conclude that the generator’s behaviour meets a high standard of trading conduct.
- A generator who isn’t pivotal is in safe harbour if it meets clauses 13.5B 1(a) and (b), but there could be situations when this isn’t appropriate —this seems to be a deficiency in the existing Code.
- The safe harbour provisions promote gaming.

Application of clause 13.5A(1) & (2):

- Initial view is that these clauses would deliver the policy intent (ie, outcomes that are consistent with the Authority's statutory objectives).
- These clauses require a counterfactual analysis – an approach commonly used in competition law. The type and complexity of the analysis required to decide whether the Code has been breached depends crucially on whether relevant comparable offer data from a period in which no generator has significant market power is available. If such data is available, the counterfactual should be straightforward to apply. If not, courts will see a flurry of mathematical simulation and modelling exercises asserted to demonstrate what offers would have been made if no generator had significant market power, technically sophisticated, but probably contested.
- Aside from case #4, the Panel considered there was insufficient information available in the materials provided to undertake robust counterfactual analysis. It was therefore unable to apply 13.5A(1) & (2) to case studies 1, 2, 3, and 5. The Panel noted that this may give an exaggerated impression of the difficulty in applying 13.5A(1) and (2) in practice, as more (and better) information would likely be available to a Court in a real case.
- The Panel noted these clauses apply to all generators irrespective of whether they individually possess significant market power. This is because it requires offers that must be consistent with offers made when *no* generator has significant market power - i.e. a smaller generator cannot “ride on the coat strings” of another generator which has significant market power. The Panel agreed this provision is required to achieve the intended outcome and did not see this provision as a problem but noted that when it is relevant the analysis will be more complex and considered it important for participants to understand the provision.

Application of clause 13.5A(3):

- While stated as a ‘purpose clause’, the Panel considered that decision-makers might use this clause in the following (non-mutually exclusive) ways:
 - To aid in interpretation of the rule in 13.5A (1) and (2), because understanding the purpose of a rule can be useful for decision-makers when applying it;
 - To provide an alternative or supplementary test when it is not possible to directly apply 13.5A (1) and (2) – this is especially relevant in relation to clause 13.5A (3)(a) which refers to prices and economic costs and may provide an accessible alternative ‘test’ if it is difficult to determine what constitutes a sufficiently robust counterfactual analysis on which to base a decision as to whether the Code has been breached;
 - To consider of the scale of any detriment arising from an apparent breach of 13.5A(1) and (2) – especially the provision in 13.5A (3)(b) regarding efficiency effects.
- For its own work, the Panel used 13.5A(3)(a) fairly extensively in case studies 1, 2, 3 and 5. This was because the Panel considered the case studies provided information that enabled a comparison of offers and economic costs (and as noted above it thought there was insufficient information to undertake reliable counterfactual analysis).
- Having said that, it was not clear how to interpret “for too much or for too long” when considering differences between offers and economic costs. From an economic viewpoint the Panel would interpret this term to mean something like “significant enough to cause detriment in a discernable way”.
- The Panel did not find the efficiency references in 13.5A(3)(b) to be directly useful in its decision-making about the case studies as the efficiency references mainly focused on longer term effects, though they could still be useful to guide the general approach.
- More generally, the Panel noted that many (perhaps all) of the elements in 13.5A(3) could be ‘read into’ 13.5A(1) and (2).

Comparison of two panels' approach and findings

Comparison of decision processes*

	Panel ABD	Panel BHR
Existing Code	<p>Started with application of safe harbour rule – considered this was relatively straightforward to apply in most cases</p> <p>If safe harbour did not apply, tried to interpret meaning of ‘high standard of trading conduct’</p> <p>Unable to reach clear view on meaning – found that it was relatively subjective in practice</p>	<p>Started with application of safe harbour rule – considered this was <u>not</u> straightforward to apply in many cases</p> <p>If safe harbour did not apply, tried to interpret meaning of ‘high standard of trading conduct’</p> <p>Unable to reach clear view on meaning – used a mix of factors to make decisions (economic, legal)</p>
Proposed Code	<p>Considered that clauses 1 and 2 require a counterfactual analysis to test whether offers are consistent with ‘no significant market power’</p> <p>Used a comparison of offer prices and costs (as per clause 3(a)) to form view of whether a breach occurred</p> <p>In conclusion, considered that there was insufficient information in case studies to perform counterfactual analysis (except case 4)</p>	<p>Considered that clauses 1 and 2 require a counterfactual analysis to test whether offers are consistent with ‘no significant market power’</p> <p>Concluded there <u>was</u> sufficient information to apply test (albeit with assumptions noted in some cases)</p> <p>Tried to use clause 3 as a cross check – but found that it was not particularly useful in practice</p>

* Based on secretariat interpretation of panel decision processes

Comparison of case studies – existing provisions

		Panel ABD	Panel BHR	Same or different views?
Case study 1	Generator A	Not in breach	Not in breach	Same
		Causative event was outside control of generator.	Causative event was an Act of God.	
Case study 2	Generator A	In breach	Indeterminate	Different
		The conduct risked prices settling at an excessive level.	Could not establish whether the generator was within safe harbour 1(c)(iii)	
Case study 2	Generator B	Not in breach	Indeterminate	Different
		Offer change did not cause market price to diverge from a 'normal' level.	Could not establish whether the generator was within safe harbour 1(c)(iii)	
Case study 3	Generator A	In breach	Not in breach	Different *
		Generator took advantage of thermal price increase to raise its offer.	There was a reasonable economic rationale for offer price	
Case study 4	Generator A	In breach	In breach	Same
		No valid reason identified to justify behaviour.	Offer didn't reflect underlying supply/demand conditions enabled by significant market power	
Case study 4	Generator B	Indeterminate	In breach	Different
		Depends on whether can justify not offering full capacity.	Generator withheld capacity even after N-1 notification	
Case study 5	Generator A	Indeterminate	In breach	Different
		Depends on whether Generator A has reasonable justification.	Generator A exercised significant market power to influence prices	

* but due to differing assumption between panels about system conditions

Comparison of case studies – proposed provisions

		Panel ABD	Panel BHR	Same or different views?
Case study 1	Generator A	Not in breach	Not in breach.	Same
		Offers likely below SRMC.	Offers consistent with expected behaviour in similar circumstances	
Case study 2	Generator A	In breach	In breach.	Same
		Offer differed significantly from SRMC.	Offer didn't reflect underlying supply/demand conditions enabled by significant market power	
	Generator B	Not in breach	In breach.	Different
		Offer price was close to SRMC.	Same reasoning as for Generator A but breach decision is less clear cut	
Case study 3	Generator A	Likely a breach	Not in breach.	Different*
		Generator raised its offer above SRMC for significant period.	Offers [likely] consistent with expected behaviour in similar circumstances	
Case study 4	Generator A	Likely a breach	In breach.	Same
		Offer price well above SRMC – although for a short period.	Offer didn't reflect underlying supply/demand conditions enabled by significant market power	
	Generator B	Uncertain but likely a breach	In breach.	Same
		Offer price above SRMC – although for short period.	Generator purposefully withheld capacity to affect prices	
Case study 5	Generator A	Indeterminate	In breach.	Different
		Depends on whether Generator A has reasonable justification.	Generator A exercised significant market power to influence prices	

* but due to differing assumption between panels about system conditions

Key learnings from panels process

- Current Code is highly problematic – meaning not clear or without meaning
- An economic-based counterfactual test is preferable to the current Code
- Operative clauses 13.5A(1) & (2) of proposed provisions are sound
- Purpose statement 13.5A(3) is too complex and long; creates more scope for litigation
- Some contextual background (e.g Explanatory Note) or guidance would be useful
- Stronger monitoring and enforcement by the Authority is essential

MDAG's view on MDAG proposal given submissions and panels

Key choices

- Keep the main pillar of MDAG's proposal, i.e keep clauses 1 and 2, and adapt clause 3 to better achieve the objective; or
- Take a different course

If we keep clauses 1 and 2, the brief would be for the Secretariat to come back with a drafting proposal based on expert technical advice that addresses issues with clause 3

MDAG's proposal

13.5A Conduct in relation to generators' offers and ancillary service agents' reserve offers

- (1) Where a **generator** submits or revises an **offer** for a **point of connection** to the **grid**, that **offer** must be consistent with **offers** that the **generator** would have made where no **generator** could exercise significant market power in relation to that **point of connection** to the **grid** for that **trading period**.
- (2) Where an **ancillary service agent** submits or revises a **reserve offer** for a **point of connection** to the **grid** (including an **interruptible load group GXP**), that **offer** must be consistent with **reserve offers** that the **ancillary service agent** would have made where no **ancillary service agent** could exercise significant market power in relation to that **point of connection** to the **grid** for that **trading period**.
- (3) The purpose of this clause 13.5A is to promote offer behaviour and efficiency outcomes consistent with competitive markets, in particular so that—
 - (a) the prices of **offers** or **reserve offers** do not exceed, by too much or for too long, the associated economic costs to the **generator** or **ancillary service agent** respectively, assuming a market in which no **generator** or **ancillary service agent** has significant market power;
 - (b) with the effect that **offers** or **reserve offers** made by **generators** or **ancillary service agents** promote efficient:
 - (i) consumption decisions by **consumers**; and
 - (ii) production decisions by suppliers (including **generators** and providers of **electricity** services); and
 - (iii) innovation and investment by suppliers and **consumers** (including the location of their investments); and
 - (iv) risk management and risk management markets,in relation to the **point of connection** to the **grid** (including an **interruptible load group GXP**) at which the **generator** or **ancillary service agent**, as applicable, submits or revises an **offer** or a **reserve offer**, and any **node** in respect of which the **offer** or **reserve offer** may have a material influence on efficiency outcomes of the kind referred to in subparagraphs (i) to (iv);
 - (c) where, for the purposes of paragraph (a) “economic costs” in clause 13.5A(3)(a):
 - (i) when assessed in relation to short-run costs, includes scarcity rents and the opportunity cost of generating **electricity** or of providing **instantaneous reserve**, as applicable;
 - (ii) when assessed in relation to long-run costs, includes recovery of capital costs with a suitable premium for risk.

Next steps

Progress on recommendations paper

MDAG's discussions paper



Feedback from industry participants



Evaluation panels

completed

to be completed



Analysis of Options

MDAG's assessment on received feedback



MDAG recommendations

Timeline

Task	Date
MDAG meeting – discuss lessons from evaluation panels process, proposed approach and first draft of recommendation paper	2 Sep
Bi-laterals with interested stakeholders to playback findings from panels (circulate panel reports and proposed options in advance)	w/c 14 Sep – send material w/c 21 Sep - meetings
Option for additional interim MDAG meeting TBC	w/c 21 Sep
Final draft of recommendations paper to MDAG	7 Oct
MDAG meeting – discuss final draft of recommendation paper	14 Oct
MDAG submit recommendations paper to Board	27 Oct
Board meeting – present recommendations paper	4 Nov