Meridian Cross-Submission

Preliminary decision on claim of an undesirable trading situation

16 September 2020

This cross-submission by Meridian Energy Limited (**Meridian**) responds to submissions received by the Electricity Authority (**Authority**) in response to its preliminary decision on an undesirable trading situation (**UTS**) released on 30 June 2020 (**the preliminary decision**).

Attached to Meridian's submission are three accompanying expert reports or opinions:

- The Brattle Group *Response to Third Party Submissions Regarding Alleged UTS* (**Brattle Report**);
- Sapere Research Group *Cross submission: UTS preliminary decision* (**Sapere Report**); and
- A legal opinion from Russell McVeagh.

The submission is divided into the following parts:

- Part A: Executive Summary
- Part B: No evidence of an extraordinary event or that confidence in the wholesale market was threatened
- Part C: "Perfect competition" is not the UTS standard
- Part D: No principled basis to find a UTS at any point in time
- Part E: General consensus that the UTS regime is not the appropriate tool for market reform
- Annex 1: Material in the complainants' submission that is factually inaccurate and/or misleading
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Part A: Executive Summary

The submissions received by the Authority in relation to its preliminary decision clearly support the concerns that Meridian raised in its initial submission, that by means of the preliminary decision the Authority has effectively proposed use of the UTS investigation framework as a means to implement market reform. The Authority has a mandate to continually monitor and evaluate the performance of electricity markets. However, the process it must adopt for any market reform it proposes is subject to a clearly defined set of procedural steps to ensure that any such reform is fairly and carefully evaluated by balancing all potential costs and benefits – including unintended costs and benefits – arising from the proposal. By comparison, the UTS regime is a narrow residual jurisdiction to apply quick fixes to resolve extraordinary events that, if left uncorrected, may threaten confidence in the market.

The Authority's preliminary decision did not clearly articulate exactly how the Authority considered the circumstances of 3 to 18 December 2019 amounted to a UTS as defined in the Code. Instead the preliminary decision focused on what outcomes the Authority would prefer or expect. This departure from the UTS test set out in the Code has effectively invited market participants to submit on all manner of grievances about the electricity market, however unfounded, in response to the preliminary decision. Of course, many market participants would prefer that wholesale prices were lower, others would prefer wholesale prices to be higher. These preferences do not assist the Authority in applying the UTS provisions in the Code.

If any of the concerns raised regarding the broader operation of the wholesale market have merit, the proper forum for those concerns would be a proposed change to the market rules and an evaluation and weighing of the respective costs and benefits, in consultation with a range of industry participants, stakeholders and experts. The Authority's UTS jurisdiction is not that forum. Numerous concerns raised in the submissions on the Authority's preliminary decision are irrelevant to the Authority's assessment of whether the events of December 2019 amounted to a UTS.

The common thread running through all of the submissions, including the complainants', is that confidence in the market is undermined when there are not clear rules as to what conduct is permitted and what is prohibited. This uncertainty is heightened when the Authority's preliminary decision misapplies the UTS provisions to retrospectively reclassify

conduct consistent with the normal operation of the market, and that was previously understood to be known and accepted by the Authority, as henceforth undesirable or inappropriate. Meridian invites the Authority to carefully consider each submission and ask whether it demonstrates that there was an extraordinary set of circumstances that threatened to undermine confidence in the wholesale market. Meridian is confident that, in light of all the evidence available, the events in late 2019 did not amount to a UTS as defined in the Code.

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Part B: No evidence of an extraordinary event or that confidence in the wholesale market has been threatened

Introduction

Part B below addresses submissions on the following:

- Offer prices in the wholesale spot market were consistent with the normal operation of the market and no evidence to the contrary has been submitted;
- The futures market continued to operate normally; and
- Managing basis risk via generation offers does not constitute a UTS.

Consistent with Meridian's submission on the Authority's preliminary decision, the general consensus (apart from the complainants) is that confidence in and/or the integrity of the wholesale market has not been threatened by the events of December 2019.

The submissions reflect the distinction between conduct that does not meet *the Authority's expectations* (which, as discussed at Part E of this cross-submission, may only properly be considered in a Code amendment process), and conduct that has threatened confidence or integrity in the wholesale market. Indeed, several market participants characterise the events of December 2019 as an ordinary, expected response to an unprecedented rainfall event – these submitters raise significant doubts about *"whether the current conduct is outside the normal operation of the wholesale market, as required for a UTS"*[1], or is indicative of *"wider systemic issues or market failure"*.[2] Indeed, the submissions suggest that while the rainfall of late 2019 was exceptional, the way the market responded was consistent with the normal operation of the market.

Offer prices were consistent with the normal operation of the market

The market behaviours and outcomes under investigation by the Authority were neither extraordinary nor unpredictable. They were no more than the normal operation of the market as it has been designed.

[1] Contact submission, available here, at [28].
[2] Mercury submission, available here, at 3.

Neither the Authority nor the complainants have presented any evidence that the events of 10 November 2019 to 16 January 2020 gave rise to any extraordinary or unforeseen circumstance that might threaten confidence in the wholesale market. To overcome this deficiency, the complainants have adopted the Authority's approach of circumventing the language of the UTS provision and adopting a fundamentally different test of comparing actual prices to a retrospective assessment of what a "workably competitive" or "perfectly competitive" market may have delivered.

Consistent with High Court precedent, Meridian submitted that a generator pricing its offers above SRMC at a given point in time does not amount to a UTS. This was reinforced in others' submissions with, for example, Contact characterising the conduct in December 2019 as a normal response to the high rainfall, observing that:[3]

> *"… over the period in question, competitive pressure in the spot market remained. All parties were competing to trade off volume and price. However the competitive dynamics that would ordinarily occur differed, as a result of South Island hydro generators managing the flooding event. Contact does not consider that the event, in and of itself, would meet the threshold of a UTS as defined in the Code."*

As far as Meridian is aware no one has submitted that Meridian's trading conduct in December 2019 was abnormal. Even the complainants submit that the behaviour was typical, as it has been a regular feature of the market across several years.[4] It was in that sense, expected, and unremarkable. Indeed, even those submissions in support of the preliminary decision appear to be focused on comparing the market outcome in the period against a perfectly competitive counterfactual, which is an entirely separate question to whether the conduct or the outcomes were, in themselves, sufficiently extraordinary to undermine market confidence or the integrity of the market at the time. For example, while Meridian strongly disagrees with the assertion that it has significant market power in any properly defined market (a matter only properly considered in an HSOTC or Code amendment process in any event), even Genesis characterised the events of December 2019 as entirely "predictable" – i.e. unremarkable and normal.[5]

As a consequence of measuring the conduct against a perfect competition standard, a number of submitters identified that the Authority's analysis that SRMC is close to $0 when hydro generators are spilling is unsophisticated and inaccurate:

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[3] Contact submission, available here, at [29].
[4] Complainants' submission, available here, at 23.
[5] Genesis submission, available here, at [7].

- Genesis observed that it *"does not accept the complainants' calculation of $0 MWh plus an arbitrary figure for operational costs is sufficiently sophisticated. It is certainly not an appropriate standard to apply ex-post in a dynamic market.*"[6]

- Similarly, Energy Link identifies that *"by definition, opportunity cost is the value of the next-best alternative. The UTS claimants also expressed the view that opportunity cost of water is zero while spilling, adding the "short-run marginal cost (SRMC) is near zero". Without providing any background or explanation, the decision paper appears to have taken this statement at face value."*[7]

During the period in question, Meridian's focus was on the safe management of the flood and minimising risks to people, structures and properties in our catchments. At the same time, we were responding to these conditions by altering our trading strategy, such that our traded water value was progressively falling, and traders were instructed to prioritise volume over price and move as much water as possible.

If the Authority considers that market confidence is undermined unless generators price at the level of SRMC, Meridian questions why the Authority has solely focussed on the actions of the hydro generators during a specified period of a hydrological event. An entirely logical question would be, why has the Authority not investigated whether other generators are similarly pricing at their SRMC, for example thermal generators commonly offer at prices in excess of their SRMC or fuel costs, this has been particularly noticeable since offer prices for thermal generation increased in Spring 2018 and have since stayed higher on average seemingly because of concerns about gas market supply risks. The submission from Neil Walbran Consulting similarly notes instances of very high North Island prices to show that North Island reserve providers do not necessarily offer at marginal cost. The reason the Authority has not investigated whether thermal generators or reserve providers offer at their SRMC is simple – the New Zealand market is simply not designed as a market where generators must bid their costs, it is designed so that generators bid prices at which they are willing to supply.

[6] Genesis submission, available here, at [45].
[7] Energy Link submission, available here, at 1.

The futures markets continued to operate normally in December 2019

Genesis correctly identifies that the Authority's preliminary conclusion that confidence in the futures markets has also been threatened, solely due to its proximity to the spot market, is not supported by *"the evidence in the futures market"*.[8] As Meridian also observed in response to the preliminary decision, the conventional test for whether futures markets were disrupted did not show any such reaction. Participation in FTR and ASX future trading remained steady during December 2019, and prices were within the ordinary variance. In those circumstances:

- there was no threat to confidence or integrity of the futures market; and

- trading behaviour, participation levels, and prices in the futures markets do not support the conclusion that there was a loss of confidence in the spot market (i.e. there was no observable shift in participation or price patterns to indicate confidence in the spot market was threatened).

Managing basis risk via offer prices does not constitute a UTS

Several parties actively acknowledged in response to the preliminary decision that management of basis risk using offer prices is part of the normal operation of the market and does not constitute a UTS.

For example:

- Mercury submits that "*it is appropriate, and has **been a feature of the New Zealand market from design**, for generators to adjust offers to manage absolute price and basis risk exposures*."[9] It goes on to say "*the use of market offers to manage such risks is aligned with promoting competition, reliability and efficiency in the electricity market. Without this ability, the only alternatives available to participants are to reduce retail competition in regions where they are exposed to price or basis risk or, in the case of hydro generators, inefficiently spill water. In the case of large nation-wide integrated generator/retailers it is necessary and efficient to manage price and*

[8] Contact submission, available here, at [35]-[36].
[9] Mercury submission, available here, at 2.

basis exposure through a combination of physical and financial risk management products."[10]

- Contact commented that "*Managing transmission constraints to avoid price separation can be consistent with efficient market operation in a competitive market.*"[11]

- Genesis submitted that *"While the Authority has in the past stated that it does not believe it is acceptable to manage locational price risk with spot offers, the Code is ambiguous on this. We believe it would be useful if the Authority provided firm guidance on the circumstances under which this approach is acceptable."*[12]

Neil Walbran Consulting's submission comments that the Authority should also be mindful of the potential unintended consequences of using its UTS powers to limit the ability of generators to use offer prices to manage basis risk, not least a potential reduction in retail competition in the North Island.[13] Only a proper Code amendment process could identify and weigh these potential unintended consequences.

Concerns were also raised regarding the Authority's process, effectively using the UTS regime to enforce previous warnings made to Meridian in a Code breach investigation context. As Genesis identified, to the extent that the Authority is dissatisfied with a generator's conduct, it should *"govern participants' actions through 'black letter' regulation rather than informal instructions."* The only surprising thing about this observation is that there is a need to make it.

Meridian also notes that the Authority's UTS process has been undermined by misleading statements made to the public by the complainants.[14] The preliminary decision has been presented as a final finding. The undermining of due process by the complainants risks a fait accompli and makes it difficult for the Authority to now find that a UTS did not occur.

[10] Mercury submission, available here, at 2.
[11] Contact submission, available here, at [38].
[12] Genesis submission, available here, at [7]-[8].
[13] Neil Walbran Consulting submission, available here, at 2.
[14] Statements undermining the due process of the Authority include: Meridian has "been caught taking Kiwis for a ride to the tune of 80 million dollars profit" (from Electric Kiwi); and Meridian has "been found rigging wholesale markets" and there has been a "cost to all consumers in New Zealand" (from Ecotricity). It should go without saying that these statements have been made without any final decision or finding from the Authority and are entirely misleading as the Authority's preliminary decision in no way suggested an "80 million dollars profit" to Meridian and explicitly stated, "there was no immediate effect on consumers due to most consumers being on fixed price contracts".

However, the Authority must nonetheless carefully and objectively consider the evidence presented and decide whether a UTS occurred as defined in the Code.

Conclusion

In summary, there appears to be broad consensus amongst industry participants that the market situation in 2019 was not unexpected, and that market participants were operating within the parameters of the Code (regardless of whether they approve of the Code as currently structured or think it should be amended). No credible evidence of a threat to confidence in and/or the integrity of the wholesale market was presented.

The Authority has recently observed in formal correspondence that its role is to:[15]

> "*Promote competition for the long term benefit of consumers – it is not to stifle opportunities for new and innovative business models or tell firms how they should manage their risks and investments. These sorts of choices are best left for entrepreneurs, and are not matters for a regulator to dictate in an open and competitive market"*

Meridian urges the Authority to turn its mind to its UTS jurisdiction in this context. Submissions received on the preliminary decision suggest that if the preliminary decision were confirmed, that would represent use of the Authority's powers with the purpose of dictating to Meridian and other generators how they should manage their risks or generation assets.

Industry consensus is that the market was operating normally in December 2019. There was no threat to confidence or integrity for the Authority to "correct". As set out in Part E, to the extent that the Authority considers it possible that intervention in the market would further its goal of promoting competition for the long term benefit of consumers, that analysis should occur through the proper Code amendment process.

[15] Letter from Authority Chief Executive to Al Yates (1 July 2020), available here, at 4.

Part C: "Perfect competition" is not the UTS standard

The Authority cannot use its preliminary decision to effectively replace the current UTS provisions in the Code with a novel test that asks whether market outcomes are consistent with what the Authority expects to observe in a workably competitive market. However, even if it could, the test of what the Authority might expect should involve an orthodox application of the "workable competition" standard. There is an obvious disconnect between the "workable competition" label applied and the actual analysis undertaken by the Authority and the complainants.

Professor Andy Philpott (on behalf of the Electric Power Optimization Centre) quickly recognised that in reality the Authority has applied a perfect competition standard:[16]

> *"The Electricity Authority has adopted this approach in making their preliminary decision using vSPD analysis that compares observed generator behaviour with what would be expected in a perfectly competitive market."*

The Authority has substituted the clear language of the UTS provisions with an overlay of a newly constructed counterfactual test based on what a "workably competitive" or indeed "perfectly competitive" market may deliver.

As noted in the appended Sapere Report, a perfect competition benchmark is not the correct test for a UTS. If it were part of the test, a perfect competition benchmark might provide a computable benchmark, but it would also introduce bias into the assessment of whether a UTS arose. Price formation in real-world markets does not reflect perfect competition assumptions. Information limitations, physical and environmental limitations, and the limitations of market rules mean that "market outcomes cannot reflect outcomes from perfect competition other than by coincidence. The Authority's test meant it assessed observed outcomes against an unobtainable standard."[17]

[16] Andy Philpot (EPOC) submission, available here, at 3.
[17] Sapere Report, at [13].

The introduction of any regulatory test to assess conduct that can only be applied retrospectively with the full benefit of hindsight is simply unprincipled, and unworkable. This same sentiment was expressed by Genesis, who submitted that:[18]

> *"We caution against applying perfect knowledge retrospectively to the operation of a dynamic market to assess that market's effectiveness. Any market assessed in this manner is highly vulnerable to perceptions of failure or manipulation, particularly when the outcome is the result of decisions made in extraordinary circumstances in real time, as was the case during the South Island flood event of late 2019."*

A genuine UTS event would not be unremarkable in real time, it would be immediately apparent, because it threatens confidence in the market. Rather, the time taken in this investigation to "uncover" the alleged UTS, itself has disrupted market confidence.

If the Authority requires almost a year to investigate an event using complicated economic modelling with the benefit of 20/20 hindsight to determine whether confidence in the market was undermined, that in itself is evidence that there has been no UTS requiring urgent restorative action.

[18] Genesis submission, available here, at [5].

Part D: No principled basis to find a UTS at any point in time

Introduction

Part D below addresses:

- That the Authority is time barred from investigating any potential UTS prior to 27 November 2019; and
- That the complainants have failed to adduce any credible evidence justifying extending the duration of the UTS period.

The Authority is time barred from investigating any potential UTS prior to 27 November 2019

The Authority does not have any jurisdiction to investigate a potential UTS arising out of events that occur more than 10 business days prior to receiving a complaint.[19] The relatively short limitation period is entirely consistent with the nature of the UTS regime. It is intended to cover extraordinary events that threaten to undermine the confidence in, or integrity of, the wholesale market. A true UTS event should be immediately noticeable such that complainants would be approaching the Authority as a matter of urgency. The mere fact that the complainants chose to do nothing until 12 December 2019 is legally, and factually, determinative of the absence of any UTS in this instance.

The complainants have failed to adduce any credible evidence justifying extending the duration of the UTS period

The Authority rightly found no evidence upon which to establish even a *prima facie* case of a UTS outside of the limited 3 to 18 December 2019 period. Indeed, for the reasons advanced in Meridian's initial submission, there is no basis whatsoever to find a UTS at any period between 10 November 2019 and 16 January 2020.

In order to extend the alleged UTS period, the complainants rely on:[20]

[19] For further detail see the appended Russell McVeagh opinion.
[20] Complainants' submission, available here, at 1-2.

- A notice issued by the Authority that they are investigating Meridian for a breach of HSOTC rules during the period from 10 November 2019 and 16 January 2020; and
- Modelling undertaken by Haast.

The HSOTC notice is simply irrelevant

The Authority's notice of its HSOTC investigation is completely irrelevant to the question of whether the events of 10 November 2019 to 16 January 2020 constitute a UTS. That notice merely sets what the Authority is investigating, which logically matches the complainants' allegation in relation to the HSOTC rules, which is an entirely separate test.

This is a critical distinction. In determining whether a UTS has arisen, the Authority is obliged to act in a judicial role. In respect of an allegation of breach of the HSOTC rules, the Authority is an investigator, and, if it considers the allegations warrant taking further, it adopts the role as prosecutor, in taking the matter to the Rulings Panel. Only the Rulings Panel can determine, in its judicial function, whether a breach of the HSOTC rules has occurred. Reinforcing the importance of this separation of functions is the express provision in the Code that the Authority must appoint a different, "independent investigator" to investigate any allegation of breach of the HSOTC rules.

It would be inappropriate for the Authority to treat an "alleged breach" of the HSOTC standard as a proven breach of the UTS standard or as setting the duration of a UTS. The fact the complainants believe it appropriate to suggest this approach reinforces the confusion that has arisen as a result of the Authority relying on its earlier HSOTC "warning letter" (in respect of an investigation that was not taken to the Rulings Panel) in support of its preliminary decision.

To proceed as the complainants suggest would cast serious doubt on not only the legitimacy of the UTS decision but also on the Authority's ability to investigate the alleged HSOTC breach in an impartial manner. The Authority correctly notes in the preliminary decision "the test for a UTS is separate and a breach of the HSOTC provisions does not imply or require a UTS".[21] The Authority's notice of its HSOTC investigation plainly does not provide any justification for extending the duration of the alleged UTS.

[21] Electricity Authority Preliminary Decision, available here, at iii.

Modelling undertaken by the complainants is of limited utility

The complainants utilise a relatively straightforward repeated vSPD solve model as a proxy for what the spot market would have produced on the day as a result of assuming different historic offer behaviours from (in this case) South Island hydro generators as inputs into the System Operator's SPD market model.

Solves of vSPD with different input assumptions are limited in that they do not take into account operational, resource consent, or hydraulic limitations. For example, while it is simple enough to override all offer prices for a spilling South Island hydro station (as the complainants have done) this says nothing about whether or not the vSPD solve that results is realistic in terms of:

- Whether the station or stations that have an offer override are physically capable of achieving the outcome;
- Whether hydraulic outcomes are achievable such as balancing a chain of hydro lakes and any constraints on spillways or canals or river flows are accounted for; and
- Whether the resulting downstream flows and lake levels are compliant with resource consents and safe operating limitations during a severe flood event.

All of the complainants' vSPD modelling simply resets offer prices in the market and does not attempt to account for the real-world factors above. It would be difficult for the complainants to do so without a detailed understanding of the schemes, power stations and associated resource consents and health and safety requirements. The Authority's modelling in the preliminary decision seeks to take into account these real-world factors by restricting the changes to Benmore where some operational limitations were understood, and hydraulic limitations could be avoided by switching generation for spill while holding lake levels and downstream flows the same in both the factual and counterfactual scenarios. The complainants have made no attempt to do this.

These shortfalls of the vSPD modelling by the complainants make it of limited value and mean that it cannot support the conclusions suggested in the complainants' submission.

In addition, while the modelling may provide a limited counterfactual reference point for the market in a short run of discrete trading periods, its robustness as a tool for analysis diminishes exponentially as the time period it is applied to increases. Running the vSPD model for the entire investigation period from 10 November 2019 to 16 January 2020, as the

complainants have done, ultimately renders results that are completely divorced from how a market would operate in practice, and is therefore of limited to no utility. The model is simply not designed to account for the dynamic process of rivalry in the market and the ways that various market participants might in the real world respond to the changes in offers and market prices that are forced by the offer overrides.

The appended Brattle report highlights further the limitations of the modelling used by the complainants and demonstrates that it would be unreasonable for the Authority to reach any findings based on that modelling.

Part E: General consensus that the UTS regime is not the appropriate tool for market reform

Meridian's initial submission set out that if the Authority wants to reform the normal operation of the wholesale market then the Code amendment process is the right way to go about it to allow for a proper assessment of the costs and benefits to consumers in the long-term.

Part E below sets out:

- The consequences of the Authority's reframing of the UTS provisions – namely that most submissions are about market reform options rather than whether the requisite elements of a UTS have been satisfied;
- The importance of clear rules for market confidence; and
- The general consensus amongst most submitters that a UTS decision is not the appropriate tool for market reform.

Most of the submissions received have limited relevance to a UTS investigation

The focus of a UTS investigation must be on whether there are extraordinary circumstances that have threatened confidence in the market. The preliminary decision instead focussed on what, after a lengthy and detailed analysis and reconstruction after the fact, the Authority would "expect to see" in a workably (tending toward perfectly) competitive wholesale market.[22]

The immediate consequence of this positioning is that most of the submissions have similarly adopted a market reform approach, rather than addressing whether the necessary elements of a UTS have been satisfied. For example:

- Andy Philpott expresses no view as to whether the events constitute a UTS, rather he offers a perspective on how the Authority should identify potential issues requiring reform in the future, "our submission is not focused on events that occurred during the

[22] The Authority also asks, in place of the UTS test in the Code, whether wholesale market outcomes reflect "market fundamentals" or supply and demand. That is not the correct test, but even if it was, the appended Sapere Report notes at [5] that according to the academic literature "[t]he relevant underlying supply and demand conditions are … not just the physical conditions of production and consumption, but also the rules governing the rights and duties of those carrying out transactions." In this sense, there is nothing to suggest that the observed outcomes were inconsistent with underlying market conditions.

period in question. We are taking the opportunity presented by a submission to give an opinion on wholesale electricity market competition in New Zealand, and the role of the Electricity Authority in regulating this market";[23]

- Genesis expressly reserved judgment on whether the circumstances constituted a UTS and instead outlined its perspective on potential issues with the wholesale market more broadly;[24] and

- NZ Steel has interpreted the preliminary decision as giving rise to an expectation that the outcome of the Authority's investigation will be refinements to market rules and/or the imposition of sanctions – neither of which are the purpose of a UTS investigation.[25]

Notwithstanding the limited relevance of the submissions received for a UTS investigation, the submissions clearly demonstrate a general consensus amongst market participants that:

- It is important to have clear rules that are applied consistency; and

- It is inappropriate to use a UTS regime as the mechanism for market reform.

It is important to have clear rules that are applied consistency

Meridian fully endorses the recent statement of the Chief Executive of the Authority that:[26]

> *"Reactionary and alarmist changes in direction are likely to work against the long-term benefit of consumers. A lack of transparency and consistency in regulation will deter the investments New Zealand needs to transition to a low-carbon future."*

The preliminary decision is entirely inconsistent with previous decisions of the Authority, which gives rise to the undesirable situation of market participants not being able to assess the lawfulness of their conduct in advance. As Genesis rightly identified:[27]

[23] Andy Philpot (EPOC) submission, available here, at 3.
[24] Genesis submission, available here, at [2].
[25] NZ Steel submission, available here, at 1.
[26] Letter from Authority Chief Executive to Al Yates (1 July 2020), available here, at 3.
[27] Genesis submission, available here, at [30].

> *"The Authority's position could thus be summarised as "it is unacceptable to structure offers to manage transmission constraints, except when the Authority determines it is acceptable, which will be made clear ex-post". It should not be controversial to state that this is not a workable standard in practice."*

Meridian agrees with the view expressed by Contact that:[28]

> *Regulatory certainty and consistent application of regulation is essential.*

Even the complainants are in agreement that clear rules as to what is permissible are essential for confidence in the market:[29]

> *Confidence in, and the integrity of, the market requires clear and enforced rules that protect against opportunistic behaviour and abuses of market power.*

Even though Meridian and the complainants have different views as to what an appropriate set of rules may be, there is agreement that the rules need to be clear in order for market participants to have confidence in the market.

There is a general consensus that a UTS decision is not the appropriate tool for market reform

As mentioned above, the events of 10 December 2019 to 16 January 2020 represented nothing more than the normal operation of the market as currently designed. It is of course within the remit of the Authority to change the design of the market to introduce a new normal. But any market reform needs to be carried out in a considered manner to properly allow due evaluation and weighing of any unintended consequences resulting from market redesign.

It is clear from the submissions received that many market participants are concerned that the Authority is inappropriately using this UTS decision to fundamentally change the design of the market:

- Trustpower observed that *"if the Authority wishes to introduce a prohibition on generator offers being used to manage transmission constraints, this should be*

[28] Contact submission, available here, at [34].
[29] Complainants' submission, available here, at 29.

considered as a policy matter rather than indirectly introduced via the Authority's compliance activities. Any reset of the boundaries for behaviour within the market should occur ex-ante through an appropriate regulatory instrument (i.e. code change, issuance of guidelines etc.)"[30]

- Contact similarly commented that *"to the extent that the Authority considers that any policy change is required to address the concerns raised in its preliminary decision, Contact does not consider that this should occur through a UTS compliance process."*[31]

- Mercury also *"does not consider the UTS provisions are the most appropriate arrangements to address issues of market conduct compared to transparent and effective conduct provisions."*[32]

This is not a case where market participants are demanding that a proper market reform process be followed for the sake of it. The effective rule change as a result of any UTS finding in this case would likely have material consequences for the operation of, including future investment in, the New Zealand electricity market. These consequences need to be properly evaluated.

Such a process is also required to clearly articulate what any new rules might be, for example, whether the new rule is that generators must price at SRMC, or that they must be blind to the cost of a transmission constrain binding, or both. The scope of the rule would also need to be clearly expressed, for example whether the rule is only applicable during spill, or generally and whether the rule only applies to hydro generators, or to all generators and ancillary service agents.

To that end, Meridian agrees with the observations made by Energy Link during the submission process. In particular, Energy Link highlights that implementing policy changes by way of a UTS decision without a proper robust consultation process that allows for a proper consideration of the costs and benefits is "playing roulette" with the electricity market:

"It is our observation that relative to when ECNZ managed hydro storage, Meridian provides a significantly higher level of supply security. Consumers benefit from this high level of supply

[30] Trustpower submission, available here, at 2.
[31] Contact submission, available here, at [32].
[32] Mercury submission, available here, at 3.

security during dry periods when inflows are below average and hydro storage falls below what might otherwise be expected given the time of year.[33]

…

Nor does the decision paper consider whether, by upholding the UTS decision, there is a risk that the lakes will be manged less conservatively in the future with the objective of reducing the probability of spill. If offer prices are regulated, or effectively regulated by virtue of the UTS decision being upheld, then the value of Meridian's current long-term storage strategy might fall below its opportunity cost, which could trigger a move to a lower level of supply security.[34]

…

Put another way, in the longer term there are trade-offs between spill and security, and these are taken into account by market participants when formulating strategies and operating according to those strategies. It is essential that those trade-offs are considered, to reduce the potential for unintended consequences. For example, we could end up with a uniquely Kiwi take on the 'missing money' problem that is well known in competitive energy-only electricity markets. Consumers certainly want cheap power, but as we know, the vast majority of consumers also place a high value on having a secure supply.[35]

…

The link between the wet period which is the subject of the UTS, and the swaption is not obvious, but the swaption, and the high level of retail competition, will no doubt be factored into Meridian's storage management strategy, and we suggest this should be considered along with our suggestions above. As above, this is all about avoiding unintended consequences.[36]

Neil Walbran similarly identifies that a potential unintended consequence of the preliminary decision is the reduction of competition in the North Island retail markets as a result of insufficient risk management tools available to South Island generators to manage their North Island exposure. Neil Walbran warns that:[37]

Should the preliminary UTS decision become final in its current form it would risk reducing this competitive pressure. This would be to the long term detriment of North Island consumers, and to New Zealand consumers as a whole.

Meridian reserves its position in relation to the unintended consequences identified by these independent experts. However, what is clear from these observations is that the

[33] Energy Link submission, available here, at 1.
[34] Energy Link submission, available here, at 2.
[35] Energy Link submission, available here, at 2.
[36] Energy Link submission, available here, at 3.
[37] Neil Walbran submission, available here, at 2.

Authority is seeking to reform the design of the market and that there are clear risks of unintended consequences that need to be considered in the proper forum (not a UTS investigation).

Annex 1: Material in the complainants' submission that is factually inaccurate and/or misleading

This list is not intended to be comprehensive.

Reference	Quote	Meridian's response
Page 1, bullet 1	"Our views align with the Electricity Authority's High Standard of Trading Conduct (HSOTC) investigation which alleges Contact was in breach between 11 November 2019 and 28 December 2019, and Meridian was in breach between 10 November 2019 and 16 January 2020"	The suggestion that the complainants' views align with the views of the Authority's HSOTC investigation mischaracterises the status and nature of that investigation. Although the Authority has opened an investigation into the "allegations" it would be highly inappropriate and in fact unlawful to form any views until the investigation has been completed. Furthermore, the Authority does not have any jurisdiction to determine whether the HSOTC rules were breached – that is the role of the Rulings Panel.
Page 1, footnote 2	"The analysis in this submission is based on SRMC = $0.01MWh."	By adopting an assumption that the SRMC of Meridian whilst spilling was only $0.01MWh, the figures quoted throughout the submission overstate any hypothetical impact of the conduct. This position is also inconsistent with the complainants' concession in footnote 3 of the complainants' letter to the Authority on 12 December that "We chose $5 to reflect: (i) the water value was virtually $0 for the entire period (11th Nov to 9 Dec), but there may be some O&M costs etc which could mean SRMC is above zero". The inaccurate impression generated by adopting that erroneous assumption simply cannot be corrected by including an analysis based on a SRMC of $5/MWh and $6.35MWh in an Appendix.
Page 1, footnote 5.	"The Authority describes unnecessary spill as "excess spill" "where generators spilled water in preference to lowering their offer prices""	The complainants have misquoted the Authority's approach to determining the amount of excess spill. At no point did the preliminary decision define "excess spill" to mean "where generators spilled water in preference to lowering their offer prices". The Authority set out, at paragraph 14.4 of the preliminary decision, a three limb test of what constituted excess spill that appropriately recognised operating constraints, resource consent constraints and transmission constraints.
Page 5	"We consider that withholding of capacity and unnecessary spill of water is an abuse of market power"	Meridian did not, at any stage during the relevant period, withhold capacity. Meridian made offers for its entire operational capacity taking into account both operational and resource consent constraints. The suggestion by the complainants that "unnecessary spill" does not consider such constraints is simply wrong and misleading. The complainants have failed to show the requisite causal connection between the existence of "market power", which would require an assessment of what the relevant "market" is, and the conduct of

Reference	Quote	Meridian's response
		"withholding of capacity and unnecessary spill of water". The evidence clearly demonstrates that the conduct was engaged in by three different generators, which is the antithesis of an "abuse of market power".
Page 10	Various quotes from Meridian and Powershop submissions dated 2011	Meridian and Powershop comments from the 2011 UTS investigation have been selectively quoted in the complainants' submission. To give the full context, in 2011 the Authority found that a UTS developed on 26 March 2011 because the events on that day threatened, or may have threatened, trading on the wholesale market for electricity and would be likely to have precluded the maintenance of orderly trading or proper settlement of trades. The Authority gave as reasons for the decision that Genesis offers set the market prices for Hamilton and regions north of Hamilton at around $20,000 during trading periods 22 to 35, during a transmission outage. In the context of the 2011 UTS, it was abundantly clear from a number of market indicators that confidence in the market had been shaken. The question then for submitters like Meridian was how, following the finding of a UTS, prices should be recalculated over the relevant fourteen trading periods. The Authority was considering adjusting Huntly offers to reflect the long run marginal cost (LRMC) of new entrant diesel generation or demand response at around $3,000/MWh. Meridian considered this too high, however the submissions at the time clearly stated that a UTS investigation is not the best place to have a policy debate about how generators should offer, rather Meridian sought a pragmatic normalisation of prices to correct the UTS. Meridian was clear that "the Authority should not, in the context of a UTS investigation, attempt to either: a) prescriptively describe the boundary between acceptable and unacceptable offers: it is enough to state that the 26 March situation was clearly across the line; or b) set prices at what the Authority considers the "right" level."
Page 21	"The Authority can consider both purpose and effect: We draw parallels with the Commerce Act cartel provisions under which it does not matter whether the purpose or effect was to lessen competition for there to have collusion"	It is entirely unclear what the relevance of an entirely different prohibition in a different legislative framework is to the investigation of a UTS.

Reference	Quote	Meridian's response
Page 23	"Historical evidence of what has happened in the market – there appears to be an ongoing pattern of behaviour which should be addressed. … To the extent the Authority considers Meridian's conduct is repeated and/or ongoing should weight against Meridian in both the UTS decision and HSOTC investigation."	Meridian agrees with the complainants that its conduct was normal, ordinary and unremarkable. However, Meridian disagrees with the conclusion that the complainants draw from this observation. The concession that there is an "ongoing pattern of behaviour" recognises that the conduct is the very antithesis of extraordinary conduct that could constitute a UTS.
Page 23	"Meridian appears to have ignored warnings by the Authority"	The Authority does not have the jurisdiction to determine whether there has been a breach of the HSOTC provisions. The Authority elected to not take the case of Meridian's conduct on 2 June 2016 to the Rulings Panel for a determination as to whether the HSOTC provisions had been breached. A warning letter by a body acting in a capacity as a prosecutor has no formal legal status. Meridian's longstanding position has been that its conduct did not breach the HSOTC provisions. Meridian has always been entirely transparent about this and has asked the Authority on many occasions to clarify the trading conduct provisions in the Code.
Page 24	"Absence of tools to hedge locational risk is no defence against misuse of market power and should not be treated as a mitigating factor"	The Supreme Court has been clear that in assessing whether a firm with a substantial degree of market power has misused its market power (or taken advantage of its market power to adopt the actual statutory language in s 36 of the Commerce Act) requires a counterfactual assessment of whether the firm would have engaged in the same conduct but for its substantial degree of market power. The absence of tools to hedge locational risk is a legitimate business justification why any firm (not just a hypothetical firm with a substantial degree of market power) would use offers to manage this very real risk. Accordingly, it is a defence against any allegation of misuse of market power as the market power is not causative of the trading strategy.
Page 29	"Meridian is gross pivotal 100% of the time in the South Island which provides it with considerable ability to mis-use market power to the (long-term) detriment of consumers"	The statement that Meridian is gross pivotal "100% of the time in the South Island" is factually incorrect. The complainants cite the MDAG "High Standard of Trading Conduct Provisions" Discussion Paper in support. As set out in Meridian's response to MDAG, the gross pivotal analysis is highly dependent on what methodology is adopted and estimates of how often one, or more generator, is gross pivotal in the South Island range from 9% to 100% of trading periods. Furthermore, by focussing on gross pivotal status, the complainants ignore a material factor in the decision making process of vertically integrated gentailers. The existence of a retail contract book significantly limits the ability of any vertically integrated generator who may temporarily be "gross pivotal" from misusing its gross-pivotal status to the detriment of consumers. Gentailers have an incentive to

Reference	Quote	Meridian's response
		ensure that they generate at least as much volume as their retail contract book and generally offer volumes to cover that contract position at very low prices to ensure those volumes clear.
Page 29	"The decision should be explicit about all elements of the trading situation that were undesirable, including fault"	The complainants appear to have misconstrued what the purpose of a UTS finding is. The UTS provision is aimed at corrected an extraordinary circumstance that threatens to undermine confidence in the market. "Fault" is a completely foreign concept to the UTS regime and Meridian cautions the Authority against trying to introduce any fault-based element to the UTS regime. The introduction of a fault-based element will make it more difficult for the Authority to determine that there has been a UTS and provide urgent remedial relief. Furthermore, for those elements of the Code where fault is required to be established and the focus is on punishment rather than relief, the Authority does not act as the judicial decision maker.

Attachments

Brattle Report

Sapere Report

Russell McVeagh Opinion