MINISTERIAL BRIEFING



Electricity Authority: HSOTC Compliance Investigations

Date:	Fri, 16 Apr 2021			Priority:			High		
Security classific	ecurity In Confidence assification:			Electricity Authority reference number:		BR 21-0018			
Action county this briefing is for noting									
Action sought – this briefing is for noting.									
				Action			Deadline		
Hon Megan Woods				note advice provided in this Briefing consult with relevant Ministers			22/04/2021		
Minister of Energy and Resources				Consuit with relevant will instens					
Appendices included Notices				of decisions and communications plan					
Contact for telephone discussion (if required)									
Name			Position		Te	elephone		1st contact	
James Stevenson- Wallace		on-	Chief Exec		S 9(2)(a)		✓		
Sarah Gillies			General Ma Monitoring		5	S 9(2)(a)			
	I					ı			
Drafter Sally Aitken		l		Position Commu		Commun	nications Lead		
Authori	sation	for pu	blication or	n Authority website			☐ Approved		Declined
The following departments/agencies have been consulted									
Minister's office to complete:				☐ Approved			☐ Declined		t
				□ Noted			☐ Needs change		
				Seen			Overtaken by Events		
				See Minister's Notes					

Comments

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Purpose

This paper provides you with information on the outcome of the investigations into alleged breaches by Meridian and Contact of the high standard of trading conduct (HSOTC) provision in the Electricity Industry Participation Code during the period November 2019 to January 2020.

Recommended action

Hon Dr Megan Woods, Minister of Energy and Resources

It is recommended that you:

1. **note** the contents of the briefing;

Foldbue.

Noted

2. **arrange** for your office to provide a copy of the briefing to the Hon Dr David Clark, Minister for State Owned Enterprises.

Noted

James Stevenson-Wallace Chief Executive The Electricity Authority

16 April 2021

Hon Dr Megan Woods Minister of Energy and Resources

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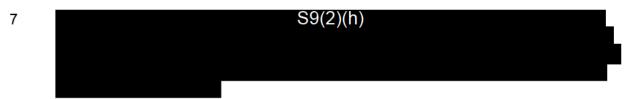
Key points

- The Authority has completed its investigations into the alleged breaches by Meridian and Contact of the high standard of trading conduct (HSOTC) provision in the Electricity Industry Participation Code (the Code) during the period November 2019 to January 2020.
- The Authority's Board has decided not to lay formal complaints with the Rulings Panel. In doing so, the Authority has decided to discontinue the investigations.
- The Authority received the alleged breaches as part of the claim of an undesirable trading situation (UTS) from Haast Energy Trading, Ecotricity, Electric Kiwi, Flick Energy, Oji Fibre, Pulse Energy Alliance and Switch Utilities (Vocus).
- The Authority's investigator advised that based on the information available, Meridian and Contact did not breach the high standard of trading conduct based on findings that the conduct during the period was sheltered by one or two of the 'safe harbour' provision.
- A key finding of the investigator was that Contact and Meridian maintained their offers at generally consistent levels, despite the water having zero value when being spilled under flood conditions. This conduct is specifically sheltered by the safe harbour provisions in this situation.
- The current trading conduct provisions were added to the Code in 2014 as a low-risk, light-handed approach to improve confidence in the efficiency of prices when competitive pressures in the wholesale market are weak. The Authority considers a lack of clarity in how the rules are currently structured presents interpretation issues and challenges for how the standards are applied in practice.
- The HSOTC provisions have been considered repeatedly since their implementation and
 the interpretation of the rules has evolved over time. In November 2017, a review was
 commissioned and completed in December 2020 after multiple rounds of consultation and
 the involvement of independent expert panels to test the current and proposed rules
 against real-life case studies.
- The review has been comprehensive, complicated and at times, contentious. The Authority recently consulted on proposed changes, which include removal of the existing safe harbour provision. Most submitters agree with the proposed changes.
- The Authority is due to reach a decision on the new HSOTC provisions in June 2021. The
 Authority expects the proposed changes will provide clarity and strengthen confidence in
 the wholesale electricity spot market for the long-term benefit of consumers. Part of the
 proposed changes includes removing the existing safe harbour provisions. Most submitters
 agree with the proposed changes.
- The Authority will notify all parties to the investigations of the outcome on 22 April 2021 and provide them with a copy of the investigator's reports. The parties will be informed they have until 7 May 2021 to lay a formal complaint with the Rulings Panel.
- The Authority will publish the Notices of the Authority's decisions on our website on 22 April 2021, after parties have been notified. We will communicate the decisions through a media statement and through the Authority's weekly newsletter, Market Brief.
- The Authority expects and has planned for negative commentary in response to the
 outcome of these investigations. Included in this briefing is the Authority's key messages
 and media statement. We have confirmed the communications approach with your Private
 Secretary and with MBIE.
- The Authority is also working on a separate review of 2019/20 wholesale market prices. This review is focusing on competition in the spot market since the unplanned Pohokura outage in late 2018. As part of the review, the Authority will look at the structure, conduct and performance of the spot market.

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The Authority's decision on the alleged breaches by Meridian and Contact of the high standard of trading conduct rules

- These investigations concern the alleged breaches by Meridian and Contact of the high standard of trading conduct (HSOTC) provision in the Electricity Industry Participation Code (the Code) during the period November 2019 to January 2020.
- The allegations against Contact and Meridian were made as part of the 2019 claim of an undesirable trading situation (UTS) and concerned the offers made by Meridian and Contact when they were spilling water during flood conditions in the South Island.
- The claimants of the alleged breaches were Haast Energy Trading, Ecotricity, Electric Kiwi, Flick Energy, Oji Fibre, Pulse Energy Alliance and Switch Utilities (Vocus).
- 4 Genesis Energy Limited, Mercury NZ Limited, Nova Energy Limited and Todd Generation Taranaki Limited joined each investigation as affected parties.
- 5 The investigation process is separate from the UTS because:
 - (a) The UTS responds to the impact on the market, without assigning blame
 - (b) The compliance investigations test whether the conduct complied with the HSOTC provisions in the Code.
- On recommendation of the Authority's investigator¹ the Board decided to discontinue the investigations. This means the Authority will not be laying formal complaints with the Rulings Panel. The Rulings Panel deals with complaints about breaches of the Code, appeals against certain decisions and resolves certain disputes relating to the Code.



Trading conduct and safe harbour rules

- 8 Most rules in the Code are prescriptive about participants' obligations. However, the high standard of trading conduct (Part 13 of the Code) provision is concerned with conduct and is expressed in terms of broad behavioural standards.
- Behavioural standards specific to trading behaviour are common to many forms of markets to help maintain the integrity of the market. The adoption of standards are useful where bright-line tests are not practical: precise rules are appropriate where it is possible to stipulate required behaviour in advance, but standards are necessary where it is not practical to specify behaviour in advance (or where the application of the rule may depend on the circumstances, and the market regulator must determine after the event whether the behaviour met the rule). Behavioural standards are associated with appropriateness of trading behaviour i.e. promoting participants to consider whether their offer behaviour will withstand publicity and scrutiny.
- Well-functioning electricity markets incorporate mechanisms to prevent the abuse of market power but also allow for prices to rise to signal genuine scarcity of fuel (and support

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¹ The Authority appointed the investigator under the Enforcement Regulations. The Authority appoints its own compliance staff as investigators, who are required to independently undertake their regulatory role. The Authority must ensure the investigator has the requisite skills and is free of conflicts of interest.

prioritisation of fuel for electricity generation). In designing the existing rules, the Authority was concerned that in situations where demand cannot be met without the services of a specific generator (pivotal), that generator could set the price in the market and may have an incentive to set it *very* high.

- At various times and locations, generators may have the ability to exercise significant market power when the electricity supplied by these participants is necessary to ensure supply and demand are balanced. A generator may be pivotal in an entire island or both islands or a smaller region. 'Pivotal situations' refer to situations where competition in an area is temporarily reduced generally due to a short-term transmission constraint and are contrasted under the rule with open market situations.
- The current trading conduct rules require a generator to make offers in a manner consistent with a 'high standard of conduct' (13.5A). 'High standard of conduct' is not explicitly defined. Instead, where the generator satisfies a set of conditions, known as the *safe harbour rule* (13.5B), they automatically satisfy the standard.
- To fall within a safe harbour a generator must, at a minimum, offer all its available generating capacity, and submit and revise offers in a timely manner.
- In situations where a generator is 'pivotal', the safe harbour rule explicitly requires one of three further conditions to comply:
 - i. market price does not increase materially as a result of the generator's offers when a generator is pivotal; or
 - ii. offers when a generator is pivotal are generally consistent with offers when it is not; or
 - iii. the generator can demonstrate it has not benefited financially.

The investigations concluded the safe harbour provisions were met

- The Authority's investigator concluded that Meridian and Contact did not breach the high standard of trading conduct (13.5A) because available capacity was offered, offers were made and revised in a timely manner, and one of the set of conditions of the safe harbour rule was met (13.5B applied). Specifically, both generators demonstrated consistent offers in periods where they were pivotal and offers in periods where they were not.
- This is referred to as 'static offer behaviour': Contact and Meridian generally maintained their offers at a static-level from period-to-period despite the value of water dropping to zero value when spilling occurred under flood conditions.
- In this case, Contact and Meridian offers were consistent from one trading period to the next, because they were of a static nature. That is, offers were not actively changed from preceding trading periods, and prices did not move downwards in response to an abundance of fuel (water).
- Such behaviour can be contrasted with 'dynamic' offer behaviour that would be expected in the circumstances to result in prices decreasing as a result of the excess water (or result in prices increasing as a result of water shortages).
- The investigation also assessed that the offer prices and quantities put forward by generators when they were in a pivotal position did not result in a material increase in final prices when compared with the final prices in either the immediately preceding period or comparable periods where the generator was not pivotal. Specifically, the Authority's investigator found that a second condition under the safe harbour rules was met.
- In summary, the Authority's investigator advised that based on the information available, Meridian and Contact did not breach the high standard of trading conduct based on findings that each generator complied with one or two of the safe harbour provisions. On advice, the Authority has decided to discontinue both investigations. Once this decision is notified the

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- claimants (or any other participants) may lay a formal complaint with the Rulings Panel within 10 working days.
- Note that for the safe harbours to apply and for the behaviour not to be a breach of the high standards of trading conduct, one, <u>but not necessarily all</u>, of three conditions must be satisfied.

Issues raised in the undesirable trading situation (UTS) investigation

- The claimants alleged Contact and Meridian's behaviour breached the high standards of trading conduct and the scale and nature of the breach constitutes an undesirable trading situation (UTS). The UTS and the Code-breach processes are appropriately run independent of each other.
- In December 2020, the Authority concluded its investigation of the claim and found that there was a UTS between 3 December and 27 December 2019. The Authority is currently consulting on actions to correct (consultation closes on 27 April 2021).
- The UTS decision refers to a *confluence of factors* that made the situation unusual one factor was Meridian's decision to withhold generation to avoid the HVDC binding. This factor touches on the quantities and prices offered by Meridian as a generator, and this individual participant offer behaviour was considered separately as part of this HSOTC investigation (as discussed above).
- The failure of the HVDC to bind meant prices between the islands did not separate. When prices separate under the conditions such as those prevailing at the time, there is downward pressure on South Island spot prices. Meridian's decision to avoid the HVDC binding, along with other factors, indicated to the Authority that competitive pressure may have been reduced for the duration of the UTS period. This confluence of factors allowed prices generally to stay high for an extended period.
- The HSOTC investigation assessed that the offer prices and quantities put forward by generators when they were in a pivotal position did not result in a material increase in final prices when compared with the final prices in either the immediately preceding period or comparable periods where the generator was not pivotal. Specifically, the Authority's investigator found that a second condition under the safe harbour rules was met. For emphasis, the distinction here is that the Meridian's actions did not increase the prices, pertinent to the HSOTC safe harbour provisions assessment, but the decision to avoid the HVDC binding contributed to a lack of competitive pressure that worked against prices falling despite abundant fuel (allowed prices generally to stay high).
- While the UTS identified that the lack of competitive pressure resulted in market outcomes that would not have been reasonably expected by market participants given the underlying conditions, the offer behaviour relevant to the high standard of trading conduct assessment was sheltered by the safe harbour provisions.

Reform of the high standard of trading conduct provisions

- The provisions have been considered repeatedly since their implementation and interpretation of the rules has evolved over time. The Authority has considered several potential or alleged breaches including five formal investigations. The Authority has not laid any formal complaints with the Rulings Panel largely because the parties alleged to have breached were sheltered by the safe harbour provisions.
- In 2017 the Authority advised Meridian that it does not consider managing transmission constraints to cover its risk to be consistent with a high standard of trading conduct. This situation involved Meridian submitting high offer prices while it was pivotal to avoid the HVDC binding (reaching capacity) and therefore avoiding price separation between the North and South Islands. At the time, the Authority considered this behaviour did not

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comply with a high standard of trading conduct and issued a warning letter to Meridian. The Authority did not lay a complaint with the Rulings Panel because it was the first serious test of the Code's high standard of trading of conduct provisions and its interpretation was still evolving.

- In response to this case, the Authority instigated a comprehensive review of the HSOTC provisions which is part of a suite of wholesale market projects. The Authority expects to reach a decision on the new HSOTC provision in June 2021. Part of the proposed changes includes removing the existing safe harbour provision. Most submitters agree with the proposed changes.
- As part of the review, the Authority has publicly acknowledged that there are problems with the current 'safe harbour' provisions, including that the provisions may shelter and facilitate behaviour inconsistent with a high standard of trading conduct, and that the provisions are difficult to apply in practice.
- The Authority expects the proposed rule to strengthen confidence in the sector and build on our response to the Electricity Price Review (EPR) recommendation relating to the wholesale market. The Authority will complement changes to the HSOTC provisions with an active monitoring regime through better resource in our monitoring, enforcement and compliance functions. We've worked with MBIE to push for higher penalties and we are pleased to see this included in MBIE's recent consultation on legislative changes.
- Your office has previously been briefed on the intended new trading conduct provisions. The proposed provisions aim to clarify expected behaviours of market participants.

Communication of the decision

- The Authority will notify all parties to the investigations of the outcome on 22 April 2021 and provide them with a copy of the investigator's reports. The parties will be informed they have until 7 May 2021 to lay a formal complaint with the Rulings Panel. If a formal complaint is laid, then the Authority will be a party. This means the Authority is limited in what it can publicly say about the matter, until this period has expired.
- The Authority will publish the Notices of the Authority's decisions on our website on 22 April 2021, after parties have been notified. We will communicate the decisions through a media statement and through the Authority's weekly newsletter, Market Brief.
- The Authority expects and has planned for negative commentary in response to the outcome of these investigations. Included in this briefing is the Authority's key messages and media statement. We have confirmed the communications approach with your Private Secretary and with MBIE.

List of Appendices (where multiple appendices)

Appendix One: Notices of the Authority's decisions Appendix Two: Key messages and media statement

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Appendix One: Notice of the Authority's decision (Meridian)

Notice of the Authority's decision under regulation 29 of the Electricity Industry (Enforcement) Regulations 2010

Under regulation 29(1) of the Electricity Industry (Enforcement) Regulations 2010 (Regulations) the Electricity Authority (Authority) must publicise every decision made under regulation 23(3) of the Regulations, together with the reasons for the Authority's decision.

Investigation

On 12 August 2020, the Authority appointed an investigator under regulation 12 of the Regulations to investigate the alleged breaches of clause 13.5A of the Electricity Industry Participation Code 2010 by Meridian Energy Limited (Meridian).

The breaches were alleged by Haast Energy Trading Limited, Ecotricity Limited Partnership, Switch Utilities Limited (Vocus), Electric Kiwi Limited, Flick Energy Limited, Oji Fibre Solutions (NZ) Limited, and Pulse Energy Alliance LP.

The circumstances of the alleged breaches concerned Meridian's offers when it was spilling water during flood conditions in the lower South Island between 10 November 2019 and 16 January 2020.

Genesis Energy Limited, Mercury NZ Limited, Nova Energy Limited and Todd Generation Taranaki Limited joined the investigation as affected parties. The notifying participants were also parties to the investigation.

The investigator was not able to achieve a settlement agreement because Meridian denied the alleged breaches.

The investigator considered that Meridian did not breach clause 13.5A(1) because the safe harbour provisions in clause 13.5B applied. Where a generator complies with the safe harbour provisions the generator is considered to comply with the high standard of trading conduct (HSOTC) requirement in clause 13.5A(1).

The investigator considers the safe harbour provisions create a situation where "static" offer behaviour is deemed to meet a HSOTC. The "static" offer behaviour is what the investigator considers to be the underlying issue behind the alleged breaches where Meridian maintained its offers despite the value of water having zero value when spilling water under flood conditions.

On 1 April 2021, the Authority received and considered a report and a recommendation from the investigator to discontinue the investigation.

The Authority's decision

On 1 April 2021, the Authority decided under regulation 23(3)(a) of the Regulations to discontinue the investigation.

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Reason for the Authority's decision

The reason for the Authority's decision to discontinue the investigation was that:

• The investigation found that Meridian did not breach clause 13.5A(1) because the safe harbour provisions in clause 13.5B applied.

In making its decision the Authority noted:

 Offers would normally be expected to result in lower prices in times of excess water. However, the investigation had highlighted that the safe harbour provisions had created a situation where maintaining offers at similar levels is not a breach of the trading conduct rules.

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Notice of the Authority's decision (Contact)

Notice of the Authority's decision under regulation 29 of the Electricity Industry (Enforcement) Regulations 2010

Under regulation 29(1) of the Electricity Industry (Enforcement) Regulations 2010 (Regulations) the Electricity Authority (Authority) must publicise every decision made under regulation 23(3) of the Regulations, together with the reasons for the Authority's decision.

Investigation

On 12 August 2020, the Authority appointed an investigator under regulation 12 of the Regulations to investigate the alleged breaches of clause 13.5A of the Electricity Industry Participation Code 2010 by Contact Energy Limited (Contact).

The breaches were alleged by Haast Energy Trading Limited, Ecotricity Limited Partnership, Switch Utilities Limited (Vocus), Electric Kiwi Limited, Flick Energy Limited, Oji Fibre Solutions (NZ) Limited, and Pulse Energy Alliance LP.

The circumstances of the alleged breaches concerned Contact's offers when it was spilling water during flood conditions in the Clutha catchment area between 11 November 2019 and 28 December 2019.

Genesis Energy Limited, Mercury NZ Limited, Nova Energy Limited and Todd Generation Taranaki Limited joined the investigation as affected parties. The notifying participants were also parties to the investigation.

The investigator was not able to achieve a settlement agreement because Contact denied the alleged breaches.

The investigator considered that Contact did not breach clause 13.5A(1) because the safe harbour provisions in clause 13.5B applied. Where a generator complies with the safe harbour provisions the generator is considered to comply with the high standard of trading conduct (HSOTC) requirement in clause 13.5A(1).

The investigator considers the safe harbour provisions create a situation where "static" offer behaviour is deemed to meet a HSOTC. The "static" offer behaviour is what the investigator considers to be the underlying issue behind the alleged breaches where Contact maintained its offers despite the value of water having zero value when spilling water under flood conditions.

On 1 April 2021, the Authority received and considered a report and a recommendation from the investigator to discontinue the investigation.

The Authority's decision

On 1 April 2021, the Authority decided under regulation 23(3)(a) of the Regulations to discontinue the investigation.

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Reason for the Authority's decision

The reason for the Authority's decision to discontinue the investigation was that:

• The investigation found that Contact did not breach clause 13.5A(1) because the safe harbour provisions in clause 13.5B applied.

In making its decision the Authority noted:

 Offers would normally be expected to result in lower prices in times of excess water. However, the investigation had highlighted that the safe harbour provisions had created a situation where maintaining offers at similar levels is not a breach of the trading conduct rules.

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Appendix Two: DRAFT Key messages and media statement

- The Authority has completed its investigations of Meridian and Contact's alleged breaches of the high standard of trading conduct rules in the Code.
- The Authority's investigations concluded Meridian and Contact offer behaviour did not breach
 the rules because the behaviour was sheltered by the safe harbour provisions. The Authority
 will not be laying complaints with the Rulings Panel and has discontinued the investigation.
- The events in December 2019 were exceptional. There was extreme rainfall, record-level inflows in the South Island and excess spill. Water at that time was abundant, cheap and available for generation.
- Given the abundance of fuel, the Authority agreed it was reasonable to expect more generation
 and lower prices. A confluence of factors at that time reduced the normal competitive pressures
 in the wholesale market resulting in unnecessary spill and prices remaining abnormally high
 despite the conditions. The Authority acknowledged these market outcomes were poor.
- As part of the trading conduct breach allegation, the investigator found Contact and Meridian
 maintained their offers at consistent levels during the alleged period rather than moving
 downwards in response to an abundance of fuel (water). The current safe harbour provisions of
 the high standard of trading conduct provisions shelter this behaviour
- New Zealand has a diverse electricity market and from time to time, the system relies heavily
 on one or a small number of suppliers to meet demand. A generator is considered pivotal when
 its supply is required to meet demand. Electricity markets need rules to make sure parties do
 not take advantage of such situations.
- The current trading conduct rules were introduced in 2014 to encourage the right behaviour from market participants. The Authority considers a lack of clarity in how the rules are currently structured presents interpretation issues and challenges for how the standards are applied in practice.
- The existing rules were drafted to support a fine balance between prescription and intent.
 Behavioural standards specific to trading behaviour are common to many markets. Standards
 are useful where bright-line tests are not practical: precise rules are appropriate where it is
 possible to stipulate required behaviour in advance, but standards are necessary where it is not
 practical to specify behaviour in advance.
- In the Authority's view the existing rules have not got the balance right and the safe harbour provision has sheltered undesirable trading behaviour. That's why the Authority has proposed changing the rules, including removing the safe harbours.
- The proposed reform of the trading conduct rules is the result of a comprehensive and often difficult review led by the Authority's Market Development Advisory Group. The MDAG's process meant all the issues were aired and discussed in detail. There are some different opinions, but most parties agree with the proposed changes.
- The Authority has consulted on proposed changes to the trading conduct provisions and intends to introduce new rules in June 2021.
- The review aligns with a heightened focus from the Authority on our monitoring, enforcement and compliance functions. This year the Authority will invest in, and expand, these capabilities to effect a step-change in our compliance approach.
- The Authority considers the proposed trading conduct rules will help address the acknowledged problems with the current safe harbour provisions, including that the provisions

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difficult to apply in practice and may shelter and facilitate behaviour inconsistent with a high standard of trading conduct.

- The Authority is complementing this work with an expansion of the Authority's monitoring
 capability to increase focus in this area and is working with MBIE to reform the structure of
 penalties available in the electricity sector.
- The Authority is committed to reforming the regulatory settings to ensure that all participants are held to a high standard of conduct to protect the long-term benefits for consumers.
- The proposed changes to the HSOTC rules, our uplift in monitoring and compliance, and our push for higher penalties will underpin a robust industry compliance culture and ultimately, better outcomes for New Zealanders.
- This decision is separate from the Authority's decision on the 2019 UTS and actions to correct. The purpose of the UTS process is to correct situations not necessarily attribute blame.

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DRAFT Media statement: Authority discontinues investigations on alleged breaches of high standard of trading conduct

April 2020

The Authority has completed its investigation into Meridian and Contact's alleged breaches of the high standard of trading conduct provisions of the Electricity Industry Participation Code from November 2019 to January 2020.

The investigation concluded there was no breach of the existing rules and on that basis the Board has decided not to lay a complaint with the Rulings Panel.

James Stevenson-Wallace, Chief Executive of the Authority says the investigator advised that based on the information available Meridian and Contact did not breach the high standard of trading conduct on the basis that the conduct during the period was sheltered by the safe harbour provisions.

New Zealand has a diverse electricity market and from time to time the system relies heavily on one or a small number of suppliers to meet demand. The existing trading conduct rules were introduced in 2014 to prevent suppliers taking advantage of such situations.

The trading conduct rules have been considered in several events since they were introduced, and their interpretation has evolved. The Authority considers a lack of clarity The Authority considers a lack of clarity in how the rules are currently structured presents interpretation issues and challenges for how the standards are applied in practice. As a result, these rules have been under review and the Authority has consulted on proposed changes. The Authority expects to make a final decision on the proposed new rules in June 2021.

The review has been comprehensive and well informed by stakeholders and legal experts. The Authority considers the proposed new rules will help address the acknowledged problems with the current 'safe harbour' provisions, including that the provisions difficult to apply in practice and may shelter and facilitate behaviour inconsistent with a high standard of trading conduct. Most stakeholders agree changes are necessary and the Authority is committed to finishing the process and update the rules as soon as possible.

The Authority is complementing this work with an expansion of the Authority's monitoring capability to increase focus in this area and is working with MBIE to reform the structure of penalties available in the electricity sector.

"We are committed to reforming the regulatory settings to ensure that all participants are held to a high standard of conduct to protect the long-term benefits for consumers" says Mr Stevenson-Wallace.

The Authority's decisions are published online (INSERT LINK).

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