



MAJOR ELECTRICITY USERS' GROUP

22 May 2002

Mr Bill Naik
Investigator
Commerce Commission
PO Box 2351
WELLINGTON

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

Dear Mr Naik

Submission on draft determination: EGBL application for authorisation

We welcome the opportunity to comment on the Commerce Commission draft determination of 26 April 2002 on the application by Electricity Governance Board Limited (EGBL) for authorising a new rulebook. This submission is on behalf of members of the Major Electricity Users' Group (MEUG). The members of the group have been consulted in the preparation of this submission.

MEUG supports the conclusion in the draft determination that the Commission cannot be satisfied that the public benefits of the proposed arrangements are likely to outweigh the competitive detriments.

This submission follows on from the two submissions already lodged by MEUG on 22 February and 1 March 2002. Answers to each of the 64 questions are provided given in the order and under the main subject headings as they appear in the list of questions on pages 125 to 129 of the draft determination. This submission concludes with a summary of our main comments. Appendix 1 lists abbreviations used in this submission. Nothing in this submission is confidential.

The Application

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

We agree with the Commission's analysis.

Market Definition

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

We agree with the Commission's analysis.

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Application of the Commerce Act 1986

3. <i>Does the wholesale pricing mechanism in the proposed arrangements breach s 30?</i> Because the purpose of the application is to make the rulebook and wholesale pricing mechanism effectively mandatory, the pricing mechanisms therefore breach s 30.
4. <i>Does the transmission pricing methodology in the proposed arrangements breach s 30?</i> Similarly the proposed transmission pricing methodology process breaches s 30.
5. <i>Do the cost allocation provisions in the proposed arrangements fall within the ambit of s 30?</i> As the cost allocation provisions will affect both members and non-members of the proposed arrangement, they therefore also breach s 30.
6. <i>Has the Commission correctly applied the provisions of s 30 to the proposed pricing arrangements?</i> The Commission has correctly considered if s 30 applies, and in our view it does. If the proposed arrangement had provided for contestable price discovery markets or bi-lateral pricing arrangements to evolve, then s 30 would not apply – ie this is the case at present where NZEM does not create barriers to alternative arrangements evolving.

The counterfactual

The draft determination accepts the proposition by the applicant that if the EGBL rulebook is not authorised then the counterfactual is that the Government will establish a Crown EGB.

MEUG does not necessarily agree that is the most probable outcome. As outlined in our first submission we consider that failure to gain authorisation of this application will create an incentive on those suppliers who can strike down pro-competitive rule changes to negotiate real changes to the governance arrangements of mutual benefit to both consumers and suppliers. Further commentary on why we believe the counterfactual proposed by MEUG is more likely is set out in appendix 2.

However for the purposes of this submission we have assumed the Commission's general definition of the counterfactual.

Even beyond the Commission's outline of a Crown EGB MEUG would expect that any Crown EGB would have a more welfare enhancing set of arrangements that precluded the strike down of pro-competitive rules. The arrangements would also:

- Unwind the EGBL paradigm that only directly affected parties should have voting rights and replace it with a governance structure that reflects the mandatory and common good nature of the decisions that need to be taken in the evolution of any rulebook;
- Remove the resource intensive and wasteful chapter voting processes and replace it with a less costly and more efficient structure; and
- Align the governance structure with that of MACQS, which already has authorisation by the Commission and we believe is widely considered by both suppliers and consumers to have functioned very effectively in unwinding very difficult quality and security functions into draft operational rules and contracts.

7. <i>In the absence of the proposed arrangements, would the most likely scenario be likely to include a Crown EGB established under the EAA, with the Guiding Principles contained in the GPS and with operational rules similar to those in the proposed arrangements?</i> Inappropriate "operational rules" would be amended. For the purpose of answering all other questions in the draft determination MEUG assume the Commission's counterfactual.
8. <i>Would a change to the proposed Guiding Principles so that they were more closely aligned with the principles and objectives in the GPS be likely to enhance competition or otherwise increase consumer welfare?</i>

<p>Full alignment of the Guiding Principles with the GPS would improve consumer welfare for two reasons:</p> <p>First, the GPS itself was drafted in consultation with a wide range of industry and consumer input and was finalised by officials with no particular agenda other than to maximize economic welfare. Suppliers with market power and their agents always dominated the process of deciding the Guiding Principles in the EGBL application and even the quote of the GWG in paragraph 220 of the draft determination is merely a reflection of that dominance.</p> <p>Second, with an industry EGB there is a risk that future changes to the GPS may not be accurately reflected in the Guiding Principles and if that industry arrangement were already authorised then the requirement to change would be subject to the whim of suppliers with market power. This holdout probably would not be sustainable; nevertheless pro-competitive changes to the GPS could be delayed.</p>
<p>9. <i>Would the proposed voting arrangements be likely to lessen the likelihood of the implementation of desirable pro-competitive rule changes?</i></p> <p>Relative to the counterfactual, yes.</p>
<p>10. <i>Under what circumstances would affected parties be likely to have sufficient commonality of interest to vote collectively against recommended pro-competitive rule changes?</i></p> <p>When ever commercial interests are aligned to prevent pro-competitive rules from proceeding, e.g. to agree to reduce the complexity and lack of transparency in the market. Existing suppliers have invested in systems to manage this complexity and would be loathe to simplify it as they will have to reinvest to adapt to the change (and write off investments in systems) and complexity will no longer be a barrier to new entrants.</p>
<p>11. <i>What examples are there in existing NZEM, MACQS and MARIA governance arrangements of pro-competitive rule changes being voted down?</i></p> <p>The following rules that are pro-competitive have been delayed in NZEM:</p> <ul style="list-style-type: none"> • Release of bid and offers • Release of price information close to real time as possible • Etc. <p>Members of NZEM have also promoted some rules that have been contrary to the long-term benefit of consumers such as the attempted expropriation of transmission loss and constraint rentals.</p>
<p>12. <i>What examples are there under NZEM, MACQS and MARIA of pro-competitive rule changes being implemented?</i></p> <p>We are not aware of rule changes within MARIA and NZEM that have been agreed with the members of those codes consciously knowing that their collective wealth may decrease, but that the impact on the economy as a whole would be welfare enhancing.</p> <p>As MACQS is not operational there have been no such rule changes, though the work by various MACQS working groups has been clearly focused on better outcomes for "NZ Inc." The deliberate inclusion of consumers in working groups and being directly represented on the GSC has, we believe, facilitated this process.</p>
<p>13. <i>What rules in the proposed Rulebook have the potential to be changed in a way that would enhance competition?</i></p> <p>MEUG has focused primarily on the governance rules because even if we start with a less than optimal set of operational rules, then at least if the evolution of those rules is under the best possible governance, we will be assured that the rules in the near term will be amended to be pro-competitive. However if we started with the best possible set of operational rules but let the governance be dominated by suppliers as proposed, then all the good work on the operational rules will be undone as suppliers dictate the agenda and time for further pro-competitive changes to the rules.</p>
<p>14. <i>From the consumer perspective, do the proposed voting arrangements give rise to any concerns, and if so in what areas?</i></p> <p>Two concerns:</p> <ul style="list-style-type: none"> • First, as identified by the Commission, pro-competitive rules can be struck out or delayed; and • Second, there is unnecessary cost in having voting chapters. There will be a cost to maintaining the register of voting for each chapter and in conducting votes. There may even be issues in the future about what chapter a particular rule change should apply to, and there will

<p>be a cost attached to sorting that out.</p>
<p>15. <i>What services would be likely to be provided on a competitive basis under a Crown EGB? How does this situation compare with the proposed arrangements?</i></p> <p>In our experience with the MED and Commerce Commission, where appropriate external expertise is frequently used and we expect the same under a Crown EGB. There would therefore in our view be no material difference between the levels of outsourced services from a Crown EGB relative to that of the proposed arrangement.</p>
<p>16. <i>Would the proposed provisions relating to the pricing of services to non-members result in a lessening of competition compared with the situation in the Commission's counterfactual?</i></p> <p>There will be a lessening of competition because parties with market power will dominate the rule making process in the rulebook and therefore the risk of skewing rules to favour themselves rather than new entrants or non-rulebook members is very high. By comparison a Crown EGB will be neutral and decision making processes more transparent.</p>
<p>17. <i>Would the provisions of Part C of the Rulebook relating to common quality lessen competition compared with the counterfactual?</i></p> <p>As a starting point the operational rules would probably be the same. The governance rules for Part C would be significantly different compared to a Crown EGB or the MEUG counterfactual – for the latter they would assume the existing authorised governance structure in MACQS.</p>
<p>18. <i>Would the provisions of Part D of the Rulebook relating to metering arrangements lessen competition compared with the counterfactual?</i></p> <p>As a starting point the operational rules would probably be the same. However the governance rules for Part D would be significantly different compared to a Crown EGB or the MEUG counterfactual.</p>
<p>19. <i>Would the provisions of Part E of the Rulebook relating to registry information and customer switching lessen competition compared with the counterfactual?</i></p> <p>As a starting point the operational rules would probably be the same. However the governance rules for Part E would be significantly different compared to a Crown EGB or the MEUG counterfactual. In particular it is particularly concerning that rules about switching non-TOU consumers are decided solely by competing suppliers without any consumer involvement or votes under the EGBL proposed Part E.</p>
<p>20. <i>What are the likely differences in ability between an Industry EGB and a Crown EGB to assess pricing methodologies, and what would be the benefits and detriments associated with any differences?</i></p> <p>At the start up not much difference. An EGB formed under the proposed arrangement would be dependent on the members of the rulebook resourcing the EGB to bring it up to speed – that would create concerns relative to say the Commerce Commission who already has considerable expertise in considering monopoly charges and therefore in our view would be a better party to consider transmission pricing methodologies.</p>
<p>21. <i>If there are any existing pricing inefficiencies relating to the HVDC link, would they be likely to be addressed as effectively by an Industry EGB as by a Crown EGB?</i></p> <p>A Crown EGB could make a decision whereas an EGB under the proposed arrangements would be hamstrung by the votes of parties in chapters of the rulebook because any changes would likely create clear winners and losers across the voting parties.</p>
<p>22. <i>The Commission invites comment on its assessment of the arrangements for pricing and investment decisions under the counterfactual.</i></p> <p>MEUG agrees with the Commission summary in paragraph 321 whereby under a Crown EGB a transmission pricing methodology determined by the EGB (with or without Commission authorisation) would require payment of charges probably by way of regulations. An EGB formed per the proposed arrangements would rely on quantum meruit to enforce charges. We believe the latter will add increased costs relative to the counterfactual.</p>
<p>23. <i>The Commission invites comment on its assessment of the impacts on transmission investment in the proposed arrangements relative to the counterfactual.</i></p> <p>MEUG agrees with the assessment in paragraph 332 that the proposed arrangements could lead to pro-competitive grid investment being delayed relative to the counterfactual.</p>
<p>24. <i>The Commission invites comment on its assessment that the transmission pricing methodology is likely to be similar under either governance arrangement.</i></p>

As a starting point the operational rules would probably be the same. However the governance rules for Part F would be significantly different compared to a Crown EGB or the MEUG counterfactual.
<p>25. <i>Would the provisions of Part G of the Rulebook relating to trading arrangements lessen competition compared with the counterfactual?</i></p> <p>As a starting point the operational rules would probably be the same. There is still some concern about how the common quality rules in the dispatch objective in Part C might evolve and the interaction with the reference to the dispatch objective in Part G. However the governance rules for Part G would be significantly different compared to a Crown EGB or the MEUG counterfactual.</p>
<p>26. <i>Would the provisions of Part H of the Rulebook relating to clearing and settlement lessen competition compared with the counterfactual?</i></p> <p>As a starting point the operational rules would probably be the same. However the governance rules for Part H would be significantly different compared to a Crown EGB or the MEUG counterfactual.</p>

Part I Implementation and Transitional Issues

The comments of the Commission set out in paragraphs 349 to 352 have been carefully considered. The specific comment of the Commission that requires a detailed response is contained in paragraph 352 where the Commission concludes

“that the transitional arrangements are reasonable and, being limited to a six month period, are not of undue duration. It considers that similar provisions would be likely in the counterfactual”.

MEUG does not accept either conclusion, i.e. that all of the transitional arrangements are reasonable, or that similar provisions would be likely in the counterfactual in respect of non-compliant plant and the dispensations which can be granted. This form of transitional arrangement that can lead to an asset owner with non-compliant plant receiving a dispensation for the life of the plant falls way outside the description of “not of undue duration”.

MEUG does not accept that a Crown EGB would have accepted the Agreement entered into between the GSC and Transpower particularly as this agreement specifies that clearance of the Commerce Commission must be specifically obtained.

Furthermore MEUG believes that the process by which a Crown EGB would handle “transitional dispensations” would be materially different. It is highly likely that the Crown EGB process would be transparent and that each application would be subject to cost/benefit analysis as well as consideration of the competition issues involved. The concept (and the application) of life of plant dispensations which impose costs on all end users would be subjected to intense scrutiny by a Crown EGB.

MEUG acknowledges that the Commission may have misinterpreted the effect of the transitional dispensation provisions and would therefore urge the Commission to review its preliminary view that the arrangements do not cause it any concern. MEUG believes that the “detriments” which arise from “life of plant dispensations” and “barriers to entry from potentially competitors” needs quantification by the Commission as the proposed arrangements impose costs on the economy. The “detriments” in the counterfactual would be minimal by comparison.

<p>27. <i>Would the provisions of Part I of the Rulebook relating to implementation and transitional issues lessen competition compared with the counterfactual?</i></p> <p>See comments above.</p>

Public Benefits and Detriments

Question 28 below asks if, in considering the application by EGLB and the GPS, there should be any change from the Commission's usual practice of ignoring wealth transfers that have no effect on economic efficiency. MEUG suggest:

- The Commission should treat the GPS no differently from any other Government s.26 statement to the Commission; and
- The change to the purpose statement of the Commerce Act last year so that it now reads "The purpose of this Act is to promote competition in markets for the long-term benefit of consumers within New Zealand" needs to be considered for two reasons.

First, promoting competition in itself is not the sole purpose of the Commerce Act. Promoting competition is now the means to improve the long-term benefit of consumers. Whereas before the legislative change to the purpose statement the relative effectiveness of promoting competition could use the theory and measures of economic efficiency to compare alternatives, that is no longer the case in assessing the "long-term benefit of consumers." It cannot be assumed that consumer welfare can be solely measured in efficient production and consumption terms. There will be instances where intangible factors need to be considered by the Commission when assessing what the long-term benefit of consumers will be. In the context of the EGLB application there are no intangible detriments and benefits that MEUG has identified at this stage relative to the counterfactual other than that suggested in the next paragraph.

Second, the purpose statement in our view requires the Commission, if in doubt, to have a bias towards the well being of consumers. For example if the Commission were to find that the public benefits are likely to equal the public detriments, then the Commission must take a bias towards what it views is the best long-term benefit of consumers. As all consumers that we are aware of oppose the application, then the Commission should take that intangible evidence into account and decline authorisation.

28. *Notwithstanding the Commission's usual approach of not counting transfers of wealth between one group and another either as a benefit or detriment, having regard to the principles of the GPS which emphasise the wellbeing of consumers, is there a case in this instance for recognising transfers from consumers to producers in this assessment of detriments? If so, what weight should be given to this factor when assessing detriments against benefits?*

Refer text above.

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

A Crown EGB would be likely to prioritise work to ensure the GPS outcomes were met, whereas an Industry EGB under the EGLB application might set the same agenda, but the chapter voting process might delay implementation of GPS issues relative to issues that those with market power voting within chapters might consider important.

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

Benefits and detriments are discussed in questions 33 to 48.

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

The trade-off is between a rulebook where those with market power dictate the rule change process but have more detailed knowledge (ie the application) versus a Crown EGB that has less information. However, the Commission has probably overstated the lack of information that a Crown EGB would have access to, or the incentive on a Crown EGB to develop processes to quickly obtain that information. On the other hand the Crown EGB will have a significant information advantage relative to an Industry EGB and members of chapters voting on rule changes with respect to understanding and undertaking economic analysis on proposed rule changes. This affects the relative benefits and detriments discussed in questions 33 to 48.

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

The retail market will also be affected and this is considered in the discussion on quantification of public benefits and detriments.

Quantification of public benefits

Comments on the five public benefits quantified in the draft determination follow:

- Efficiency of decision-making (NPV benefit \$28.4-\$56.7m)¹.

The major driver for crediting the proposed arrangement with a public benefit for efficient decision-making is “the informational advantages of industry participants in decision-making relative to the Crown EGB.” Because of this informational disadvantage the Commission agrees with the applicant that there will be inefficient production and investment outcomes with a Crown EGB. MEUG disagrees with this analysis because:

- We agree that suppliers may have more information on technical issues and information on how rule proposals may affect them individually commercially. But there would be sufficient incentive on a Crown EGB to purchase expertise to match at least the technical expertise of the industry. That increases the costs of a Crown EGB relative to an EGB formed pursuant to the proposal, though that effect is considered later in the discussion on the claimed benefits of lower transaction, compliance and lobbying costs. To an extent the impact of rule changes on the commercial position of each supplier is not pertinent – of course in the application that seems to be a key driver in terms of allocating votes to chapter members.
- In terms of information about what is best in the national interest, both from an understanding of the methodology for making such an assessment, conducting and then making a decision about what course of action to take – the industry is and has been and will continue to be at a severe informational disadvantage compare to a suitable regulatory body such as the Commerce Commission, the MED or Crown EGB.

The above two effects lead to the conclusion that a Crown EGB may have some technical information disadvantages but from a public policy decision making viewpoint a Crown EGB or similar will be far better equipped to analyse rule proposals using standard economic analysis than suppliers voting by way of voting rights in chapters as proposed by the applicant. MEUG therefore consider there is no benefit due to efficiency of decision-making.

- Lower cost of capital (NPV benefit \$11-\$22m)².

MEUG believe that the claimed benefit of a lower cost of capital is not at all unclear and in any case would be immaterial. For example if it could be demonstrated that the cost of capital for suppliers would rise, that effect may be in their cost of debt rather than in the overall Market Risk Premium or equity beta. Conversely the cost of debt for major users of power may go down and so too the cost of capital to those end-users. The net effect will be no change across the economy as a whole for the cost of capital across all sectors of the economy if the counterfactual were in place compared to the proposed arrangements. Appendix 4 includes further commentary on the question of cost of capital.

¹ Refer paragraphs 413 to 421 of the draft determination

² Refer paragraphs 410 to 412 of the draft determination

- Over-investment in transmission/higher transmission costs (NPV benefit \$10.7-\$21.5m)³.

In our experience with Transpower we have not seen over-investment. Quiet the contrary. And yet Transpower is a fully Government owned SOE with a Statement of Corporate Intent that requires the company to consider welfare enhancing factors before its own commercial interests. There is no reason to believe that a Crown EGB will act any differently than the existing Transpower Board when it comes to new investment – particularly as new processes through Part F assist reduce the discretionary investment making powers a Crown EGB or for that matter the existing Transpower Board may wish to make due to political pressure.

Therefore we do not believe there is any case for ascribing to the application any benefit associated with over-investment in transmission relative to a Crown EGB.

- Lower transaction, compliance and lobbying costs (NPV benefit \$5.9-\$11.9m)⁴.

The draft determination assumes that the counterfactual will lead to higher costs with officials having to be involved and increased lobbying of the members of the Crown EGB, and that therefore the proposal should be given a public benefit from the saving in these costs.

With both an industry and a Crown EGB secretarial and expert assistance to analyse a rule change proposal will be needed. With a Crown EGB officials may well undertake that work, however that does not necessarily assume they will be inefficient relative to the process under an industry EGB. Recent experience has shown that officials actively seek external experts to analyse complex issues (eg Dr Read for Transmission Loss and Constraint rentals and FTR and Dr Small for a mandatory hedge arrangement).

We do not believe that a Crown EGB will be prone to more lobbying than an industry EGB, in fact the opposite may occur. Experience to date in a number of public consultation processes (eg the Ministerial Inquiry into the Electricity Industry, various Commerce Commission processes, consultation processes conducted by Transpower and issue specific consultation by officials on a range of topics such as draft GPS text and the recent work by Dr Read and Dr Small) has shown that these processes work well when officials manage the process. That is because those processes are transparent and officials are, in our view, very sceptical of lobbying by special interest groups where particular advantages are sought for that group at the expense of the nations overall wealth.

In our experience with NZEM and MARIA to date, the same cannot be said for an industry EGB. We can see intense lobbying by generators on a number of fronts:

- To get their nominees accepted by the EGB onto working groups;
- To get the EGB to prioritise issues that suits particular suppliers;
- To get the “right” expert advisor, known of course to the supplier, to assist the EGB or the working group in considering rule changes; and
- Prior to the members of a chapter voting there will be intense lobbying and trade-offs made between suppliers to support each other on various rule changes.

For each of the above examples suppliers will have far more resources to lobby for outcomes that favour their position relative to the resources consumers can apply to such lobbying.

In addition should the proposal proceed MEUG expect intense lobbying by consumers and other affected parties to turn the rules over (the exact means is not known) because

³ Refer paragraphs 426 to 428 of the draft determination

⁴ Refer paragraphs 422 to 424 of the draft determination

inevitably the proposed arrangement will end up frustrating pro-competitive rule changes. On balance MEUG believe it is not at all clear that there will be either inefficient transaction processes or increased lobbying with a Crown EGB compared to the proposal. In fact we think the suppliers will have more incentive and opportunities with an Industry EGB to lobby and costs will increase. Therefore we believe that the Commission ascribe no net detriment or benefit for this factor.

- Improved competition for service provider roles (NPV benefit \$0.4-\$0.9m)⁵.

The draft determination has given some weight to the applicant's argument that a Crown EGB would have less contestable services than an industry EGB. The draft determination therefore assumes a 15% difference in the probability of contestability between the counterfactual and the proposed arrangements on base assumptions that \$12m per year of potentially contestable services are available and non-contestable services would increase costs by between 4 to 8 percent.

MEUG disagree with this analysis and believe there would be no material difference. A Crown EGB would have to operate in a transparent and accountable fashion for its performance and the fact that it was a public entity subject to scrutiny would incentivise it to be efficient and outsource contestable services. On the other hand an EGB formed under the proposed arrangement would be beholden to the members of the rulebook for monies to have dedicated resources and external sources and that in itself will lead to greater risk of pro-competitive rules being delayed.

The table below summarises MEUG comments on the benefits of the application relative to the counterfactual assumed by the Commission of a Crown EGB:

Draft determination benefit	NPV \$m	MEUG response	NPV \$m
Efficiency of decision-making on the generation market	28-57	Technical information disadvantages of Crown EGB can be overcome. But Crown EGB has significant informational advantages in terms of understanding and applying economic analysis to rule proposals compared to an EGB as proposed by EGBL.	Nil
Lower cost of capital	11-22	Unclear if benefit or detriment to the economy as a whole and in any case immaterial	Nil
Over-investment in transmission/higher transmission costs	11-22	Not borne out by experience with Transpower and EGB likely to be similar	Nil
Improved competition for service provider roles	3-6	Not clear this will be the outcome at all	Nil
Lower transaction, compliance and lobbying costs	6-12	Transaction costs not different. More risk of high lobbying with industry EGB than Crown EGB. Expect lobbying from consumers to turn over the rules that are as one-sided as proposed by EGBL also. This negates any claimed benefit.	Nil
Total benefits	59-118		Nil

Answers to specific questions follow:

⁵ Refer paragraphs 429 to 432 of the draft determination

33. <i>Would the cost of capital be different in the proposed arrangements relative to the counterfactual?</i> Probably not and in case immaterial. Refer discussion above.
34. <i>Would regulatory risk affect only the cost of capital for private sector interests?</i> Probably not and in case immaterial. Refer discussion above.
35. <i>What weight should the Commission give to the potential effects of a Crown EGB on productive and dynamic efficiency in the generation and service provider markets?</i> Refer discussion in text on quantifying benefits and detriments.
36. <i>Would a Crown EGB have a comparative disadvantage in deciding on recommendations to rule changes?</i> Refer discussion in text on quantifying benefits and detriments.
37. <i>If so, would it also have an impact on allocative efficiency in the wholesale electricity market?</i> Refer discussion in text on quantifying benefits and detriments.
38. <i>Would there be higher lobbying costs in the counterfactual? Is the Commission's assessment of this potential cost of an appropriate order of magnitude?</i> Refer discussion in text on quantifying benefits and detriments.
39. <i>Would industry input into a Crown EGB's investment decisions provide a restraint on the potential for over-investment and over-maintenance of the grid?</i> Refer discussion in text on quantifying benefits and detriments.
40. <i>Is the Commission's assessment of the likelihood of contestable services appropriate?</i> Refer discussion in text on quantifying benefits and detriments.
41. <i>Are there examples from other industries of the magnitude of benefits available through making services contestable?</i> Refer discussion in text on quantifying benefits and detriments.
42. <i>Is the Commission's assessment that under a Crown EGB if services were made contestable, it would also allow competitive bypass of service providers correct? If so, would the efficiency gains from that additional competition have a material impact on net benefits?</i> Refer discussion in text on quantifying benefits and detriments.
43. <i>What scope is there for the proposed arrangements to change over time to remove or lower entry barriers or improve efficiency in the relevant markets?</i> There are good incentives for a Crown EGB because it's approach has to be transparent and accountable. The proposal has less transparent and accountability because the parties who control the votes to change rules do not have to explain why they voted one way or the other.

Quantification of public detriments

Comments on the two public detriments quantified in the draft determination follow:

- Strike-down of pro-competitive rules (NPV detriment \$33-\$72m)⁶ comprising:
 - Loss of dynamic efficiencies of \$13.4-\$24.2m;
 - Loss of productive efficiencies of \$12.6-\$23m;
 - Loss of allocative efficiency of \$5.8-23.5m due to higher than contestable wholesale prices; and
 - Loss of allocative efficiency of \$1.5m due to delays in new generation investment.

⁶ Refer paragraphs 433 to 438 of the draft determination

MEUG believe these detriments are understated for two reasons:

- The demand elasticity assumption is understated when spot prices are very high and therefore the detriments are understated (refer also answer to question 59). Assuming in the future that for 10% of the time spot prices are sufficiently high to double the assumed demand elasticity, then the detriments will increase by \$3-\$7m (NPV)⁷.
- The retail market is also affected by strike down of pro-competitive rules. Dominant suppliers could under the proposed arrangement ensure non-TOU switching rules only develop at a pace that they are comfortable with. For example best practice switching practices may allow virtually daily switches to be completed using smart meter technology and better centralised data management processes. However incumbent large suppliers may be unwilling to allow those best practice options to be implemented immediately because they have such a large sunk cost in systems to manage existing switching protocols and they do not want new entrant retailers to leap frog their technology. As an approximation of the detriment of the proposed arrangement as it affects the retail market we assume an additional detriment of between \$3-\$7m⁸.
- Under-investment in transmission (NPV detriment \$29-\$54m)⁹ comprising:
 - \$3.8-\$15.5 m reduced allocative efficiency, \$8.3-\$15.2m reduced productive efficiency due to managerial slack and \$5.4m lower productive efficiency for inefficient choice of location for new investment. All these detriments are due to suppliers with market power voting against grid investment that would relieve constraints and thereby lower wholesale costs and prices. The dynamic effects are estimated at \$8.8-\$16m.

MEUG believes the dynamic effects are considerably understated. For example MEUG members in the wood processing sector have raised in various forums and with Ministers concerns about transmission constraints (as well as lack of competition overall in spot price and hedge markets) and the impact on future investment decisions to process the wall of wood about to mature. In the next ten years important decisions will be made on how much wood will be processed for added value products onshore New Zealand versus exporting logs. The decisions will mean the difference between hundreds of millions of dollars investment in New Zealand versus nothing – and one of the factors contributing to those decisions will be the risk of under-investment in transmission because suppliers can delay investment and make more margin from other captive consumers than expanding supply and allowing new entrants to compete for new demand from wood processing. We suggest that the scale of this risk would probably lead to the dynamic detriments being at least double that estimated in the draft determination.

- \$2.3m (NPV) allocative efficiency loss due to increased risk of transmission outages due to under-investment;

MEUG believes this estimate of the detriments of increased outages due to the increased risk of outages is seriously understated. In December 2001 and in February 2002 there were serious outages on the transmission grid affecting consumers in the Bay of Plenty. While statistics are difficult to obtain, the loss of production from major pulp and paper plants over those two incidents alone was probably several million dollars and in addition to that those consumers paid excessive amounts for remaining

⁷ This calculation that assumes 10% of the draft determination aggregate detriments due to strike-down of pro-competitive rules has been understated because the demand elasticity would say double at high prices. Though algebraically this may not be exactly correct, it is given as a rough approximation.

⁸ This has been calculated assuming exactly the same demand, demand elasticities etc as the calculation of detriments for the generation sector, apart from using 0.5 c/kWh rather than 5 c/kWh. The 0.5 c/kWh is an assumed average retail margin across all classes of consumer.

⁹ Refer paragraphs 439 to 444 of the draft determination

production that had to use power sourced on the spot market. The proposed arrangements that retain the dominance of Sellers that benefit from this is in our view expected to continue to have these outcomes. Therefore we believe this detriment has been understated by at least a factor of 10.

MEUG believe there are two other detriments that the Commission should consider:

- Because the proposed arrangements depend on quantum meruit for enforcement of payments, it is likely that over the 10 year horizon of the competition analysis that there will be several cases that arise. We believe this will occur because there are no grid connected consumers that we are aware of that will join the rulebook and so inevitably disputes will arise. From experience of the NZEM market there are always issues not contemplated in the drafting of the original rulebook that will need to be sorted out – and considering the EGBL rulebook is significantly more complex than NZEM the frequency of issues likely to lead to a quantum meruit resolution are likely to be numerous. Assuming on average one case per year for the next 10 years, and the resources required will be at least \$1m per case, then the detriment is at least \$6m. By comparison in the counterfactual a Crown EGB will by law recover charges without having to resort to the costly and uncertain process of asking the courts for quantum meruit.
- Quantum meruit does not cover all aspects that are needed for the core mandatory services in the industry, eg access to information. The system operator may be able to lower ancillary services charges if say all generators, both grid connected and embedded, provide certain information. Under a Crown EGB that information could be accessed otherwise the weight of the law (either under existing regulations or a new regulation) can be used. An EGB formed pursuant to the application by EGBL has no power to access that information and quantum meruit will not help. Therefore to remedy the problem the Industry EGB will have to ask a Government agency to intervene for a regulatory power to require disclosure. This will add a cost to the proposal, whereas in the Crown EGB all those regulating and enforcement powers will be established at set-up. We suggest a nominal cost of \$3m be assumed as the cost of miscellaneous regulating powers to cover issues that cannot be drawn to a conclusion using quantum meruit.

The table below summarises MEUG comments on the detriments of the application relative to the counterfactual assumed by the Commission of a Crown EGB:

Draft determination detriment	NPV \$m	MEUG response	NPV \$m
Strike-down of pro-competitive rules	33-72	Demand elasticities understated when spot prices very high, detriment increases \$3-\$7m. Detriment to retail market not included of \$3-\$7m.	39-86
Under-investment in transmission	29-54	Dynamic efficiency effect to include risk of losing wood processing investment, ie \$9-\$16m Cost of lost manufacturing due to transmission outages understated by a factor of 10, ie \$21m.	59-91
Pursuing quantum meruit cases	Nil	There will be cases that occur and the cost will be high	6
New regulations to cover issues not solvable using quantum meruit	Nil		3
Total detriments	62-127		107-186

Answers to specific questions follow:

<p>44. <i>What are the incentives on distributors to vote on reduction or elimination of grid constraints?</i></p> <p>Distributors and dominant suppliers have few incentives (may have perverse incentives), particularly relative to the end consumer who is ultimately affected.</p>
<p>45. <i>Are distributors likely to have different attitudes to elimination of transmission constraints that have security implications and transmission constraints that lead to higher energy prices?</i></p> <p>Distributors do not have to consider transmission constraints because that impacts on the energy market. Even if local demand is reduced because of line constraints, the distributor can simply increase line charges to the remaining end consumers.</p>
<p>46. <i>Quantification of the potential range of detriments indicates that the principle detriments arise from a reduction in competition in the generation markets, and the corresponding weakening in incentives for generators to be efficient. Is the Commission's preliminary assessment that under-investment in the grid would provide strong scope for generators to exercise market power correct?</i></p> <p>Refer discussion in text on quantifying benefits and detriments.</p>
<p>47. <i>The Commission's preliminary assessment is that the proposed arrangements are likely to allow generators to increase electricity prices above competitive levels. This would result from both the potential for strike-down of pro-competitive rules and under-investment in transmission. Apart from deadweight losses, are there other public detriments that would arise from an increase in electricity prices?</i></p> <p>Refer discussion in text on quantifying benefits and detriments.</p>
<p>48. <i>The Commission seeks comment on whether the issues that have been considered in this Draft Determination provide a reasonable summary of the issues of which it should be aware before making a final decision on this Application. The views of interested parties are sought on any additional issues that might be of relevance when considering the benefits or detriments to the public that might result from the proposed arrangements, should they proceed.</i></p> <p>The Commission also needs to include the detrimental effect on the retail market of the proposed arrangements, the additional cost of pursuing quantum meruit cases that will inevitably arise and the costs for targeted regulation to cover the issues that cannot be solved by quantum meruit.</p>

Draft determination

MEUG view with concern the proposition in the draft determination that the proposed arrangement could be authorised subject to conditions being granted (refer paragraph 453). The Commission has never, as far as we are aware, granted conditions on other than clearances for mergers and acquisitions. To suggest the Commission might consider at this stage in the process a set of conditions from the applicant without interested parties commenting on those conditions or suggesting alternative conditions would be unprecedented. The arrangements are complex and inter-woven, and any conditions by the applicant will need to be carefully considered and indeed the counterfactual may change (eg become the proposed arrangement with a different set of conditions). The Commission should not be the designer of the rules; but the Commission would in effect be doing that by even considering the applicant could suggest conditions at this stage. The only route for the applicant should they wish to propose conditions is to resubmit their application.

<p>49. <i>If the Commission chose to authorise the proposed arrangements, what condition(s) on the authorisation would address concerns about the potential for pro-competitive rule changes not being implemented and any negative downstream effects.</i></p> <p>That can only be determined after those conditions are made public, due consultation made, and the applicant resubmits the arrangement modified by the conditions for authorisation</p>
<p>50. <i>What would be the benefits and detriments arising from such a condition(s)? Would the imposition of such a condition(s) be consistent with the Act?</i></p> <p>We need to see the conditions and test those against alternative conditions that could be considered before benefits and costs could be assessed.</p>
<p>51. <i>Are there any other matters which the Commission could appropriately address with conditions to an authorisation?</i></p>

Not that we know of at this stage. MEUG believe the issue is not about small "conditions" being negotiated; rather it is about a fundamental review of the proposed governance.

Appendix 2 Assumptions and data

52. <i>Is it appropriate to use a ten-year time horizon for the purpose of calculating benefits and detriments?</i>
Yes, though if the outcome on both qualitative and quantitative factors were evenly balanced, a sensitivity analysis using alternative different time horizons might be appropriate.
53. <i>Are the Commission's assumptions on the magnitude of efficiency gains arising from the comparative advantage of industry arrangements relative to the counterfactual appropriate?</i>
Refer discussion in text on quantifying benefits and detriments.
54. <i>Are the Commission's estimates of the higher transactions costs in the counterfactual of an appropriate order of magnitude?</i>
Refer discussion in text on quantifying benefits and detriments.
55. <i>Are the Commission's assumptions on the potential range of efficiency losses in the counterfactual of an appropriate order of magnitude?</i>
Refer discussion in text on quantifying benefits and detriments.
56. <i>The Commission invites comment on its assessment of the magnitude of efficiency losses in the counterfactual relative to the proposed arrangements.</i>
Refer discussion in text on quantifying benefits and detriments.
57. <i>The Commission invites comment on its assessment of the likelihood that service providers and system operator roles would be made contestable under the proposed arrangements, relative to the counterfactual.</i>
Refer discussion in text on quantifying benefits and detriments.
58. <i>The Commission invites comment on its assessment of the potential for price increases, relative to the counterfactual.</i>
Refer discussion in text on quantifying benefits and detriments.
59. <i>Are the assumptions on long-run supply and demand elasticities appropriate?</i>
The long run supply and demand elasticities may be too inelastic because: <ul style="list-style-type: none"> • They are global estimates for every price. Demand elasticities should be given for each discrete price, ie in the short-run and long-run expect demand elasticities to be "average" for "average" prices and much higher in periods when spot prices are higher. • Technology has and will allow greater demand side interaction in real time and therefore make demand curves more elastic in the future, particularly during periods of high spot prices. • New Zealand specific wholesale market demand elasticities probably reflect the bias of the rules, particularly around information disclosure, that has inhibited development of demand side to actively interact in the market. If that bias is removed, demand elasticities will improve.
60. <i>The overall detriment resulting from delayed investment is calculated to be \$1.5 million NPV, reflecting the low likelihood of a dry winter. Are there any assumptions, which, if varied appropriately, would lead to a significant difference in the result?</i>
Refer discussion in text on quantifying benefits and detriments.
61. <i>Is the Commission's assessment of the magnitude of potential efficiency losses arising from a reduction in competitive pressure appropriate?</i>
Refer discussion in text on quantifying benefits and detriments.
62. <i>Is the Commission's assessment of the likelihood of under-investment in transmission under the proposed arrangements, relative to the counterfactual, appropriate?</i>
Refer discussion in text on quantifying benefits and detriments.
63. <i>Are there any assumptions which, if varied appropriately, would lead to a significant difference in the calculation of detriments arising from transmission outages?</i>
Refer discussion in text on quantifying benefits and detriments.

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

Refer discussion in text on quantifying benefits and detriments.

Concluding comments

In summary MEUG submit:

- We agree with the Commission's assessment of the scope of the application and the market definitions. In the quantification of detriments and benefits the Commission has not included an assessment of the impact on the retail market, even though it is identified as within the definition of the market affected by the proposal.
- The Commission, in our view, has jurisdiction to authorise or decline authorisation of the rulebook in whole, but not in any part of parts. This is because the rules that breach the Act on setting prices, cost recovery and treatment of non-participants cover several or all chapters. This integrated nature of the arrangement means that the Commission must consider the application as a whole not any discrete "characterisations" as submitted by EGBL. Therefore whether the spot price mechanism in Chapter G is or is not compliant with s.30 of the Act is of interest but a definitive outcome in the final determination is not essential. However in terms of a precedent, MEUG believe there are good grounds for arguing the spot price mechanism in the proposed arrangement is a breach of s. 30.
- The draft determination assessed the NPV public benefits of the proposal as between \$59 to \$118m. MEUG believe there are no public benefits because:
 - There may a comparative industry decision benefit for technical issues, but a Crown EGB would have far greater informational advantage when making economic analysis of proposals – therefore these two effects net each other out;
 - The claimed benefit of a lower cost of capital is unclear and in any case is immaterial; and
 - The claimed benefits of reduced risk of transmission over-investment, improved competition for service providers and lower transaction and lobbying costs are not justified.
- The draft determination assessed the NPV public detriments of the proposal as between \$62 to \$127m. MEUG believes:
 - The strike-down of pro-competitive rules is understated due to the demand elasticity assumption not reflecting elasticity at very high spot prices and retail market effects not being included;
 - The risk of under-investment in transmission has significantly understated the risk of production losses by end users;
 - There is an additional detriment due to the cost of having to use quantum meruit to settle issues that arise in the future – and those will inevitably arise because major users are unlikely to join the arrangements; and
 - Because quantum meruit does not cover possible issues that might arise between members of the rulebook and non-members (eg access to information issues), the proposal will need to have additional targeted regulation developed and that cost is a detriment that should be considered.

On this basis MEUG suggest the quantified NPV public detriments are in the order of \$107 to \$186m.

- Summing the above public detriments and benefits gives a range (in NPV terms) of between -\$186m (-\$67m) to -107m (\$56m). Figures in brackets refer to the upper and lower ranges assessed in the draft determination, where detriments are negative and benefits are positive. Applying the changes suggested by MEUG leads to the result that for all cases the public detriments outweigh the public benefits. Therefore the Commission should reaffirm the draft determination that authorisation should be declined.
- We believe that the Commission should not contemplate authorising the application on the basis that the applicant might mid-way through the process suggest conditions. If the Commission were to contemplate such an option then the Commission is effectively negotiating with the applicant the final form of the rules. This would be a significant departure from the approach the Commission has always taken of having either a yes or no decision and not being responsible for negotiating outcomes for authorisations. If the applicant believes they need conditions attached to gain authorisation, then the application must be resubmitted and the process restarted to allow affected parties an opportunity to make submissions on this effectively altered application.

We look forward to participating in the Commission's conference.

Yours sincerely



Ralph Matthes
Executive Director

Appendix 2: List of abbreviations

EAA	Electricity Amendment Act
EGB	Electricity Governance Board
EGBL	Electricity Governance Board Limited
FTR	Financial Transmission Right
GPS	Government Policy Statement
GSC	Grid Security Committee
GWG	Governance Working Group
HVDC	High Voltage Direct Current
MACQS	Multi-lateral Agreement on Common Quality
MARIA	Metering and Reconciliation Agreement
MED	Ministry of Economic Development
MEUG	Major Electricity Users' Group
MPWG	Market Price Working Group
NPV	Net Present Value
NZEM	New Zealand Electricity Market
RWG	Rationalisation Working Group
SOE	State Owned Enterprise
TOU	Time of Use
TWG	Transport Working Group

Appendix 2: Commentary on the counterfactual proposed by MEUG

MEUG have proposed the most likely counterfactual should the proposed arrangement fail to gain authorisation would be the negotiation of an alternative set of arrangements. The likely sequence of events following a final determination to decline the application at the end of July 2002 would be:

- EGEC would meet and ask its funders, namely NZEM, MARIA, MACQS and Transpower, whether and on what basis should it attempt to resubmit another set of arrangements for authorisation. We believe there would still be sufficient interest from those parties including consumers to continue that process.
- The Minister would ask officials to consider the implications of a decision to decline that application and in particular the impact on achieving the outcomes in the GPS. We do not believe that the Minister or officials have undertaken the preparatory work to immediately announce and implement a Crown EGB; hence there would be a window for negotiation by EGEC, suppliers and consumers to arrive at a rulebook that was mutually beneficial. This assessment is also given weight by two other factors.

First, in election year it is unlikely that a Government would trigger a political debate by announcing a Crown EGB when, as far as we know, there are few if any consumers who want a Crown EGB compared to the opportunity to negotiate a better set of arrangements. Second, most of the policies in the GPS have either been completed or work commenced under the existing codes and therefore the necessity of having closure on the combined rulebook by triggering a Crown EGB does seem weak.

Appendix 3 illustrates the progress on the GPS policies.

- We agree that a Crown EGB is possible, but it would only be after the above failure of further negotiations between consumers and the supply side. There is always the risk of a unilateral political decision to create a Crown EGB, but that does not seem likely this year as noted above and the Minister of Energy has often noted his preference for industry solutions first and intervention only if absolutely necessary.

MEUG believe the above scenario is the most likely.

Appendix 3: Progress against details of Government Policy Statement

The purpose of this appendix is to demonstrate that most of the outcomes in the GPS have been or will be achieved, despite neither an Industry nor Crown EGB having been established since the Government's first GPS announcement in December 2000. This leads to two conclusions:

- The driver to implement the GPS outcomes is occurring constantly within the existing codes of MARIA, MACQS and NZEM anyway – though the speed of how some of those rule changes are considered and implemented would be improved if consumers had greater involvement; and
- There is no immediate urgency to have a Crown EGB established straight away to ensure the outcomes of the GPS will be met – because they are being largely met anyway. Therefore the applicant's counterfactual of a Crown EGB being established immediately should the Commission decide not to authorise the application by EGBL is debateable.

GPS issue ranked by the order of the paragraph referred to in the GPS of February 2002	Winter security issue also?	Status at 22 May 2002	Further value that EGB is expected to add in achieving GPS specific outcomes
Release of information on generator offers (paragraph 15)	Yes	Proposed rule change in NZEM for release after two weeks. Consumers not involved in final NZEM decision and consistently outvoted at NZEM MPWG. Final push to adopt these was due to intervention from officials.	Almost completed, so EGB would add no value
Disclosure of spill from hydro dams (paragraph 16)	Yes	Voluntary protocol established and disclosures made public. Consumers involved at RWG that agreed protocols. MEUG expect evolution of this protocol will iron out some initial inconsistencies and make access to information easier	Almost completed, so EGB would add no value
Disclosure of hedge prices and promotion of hedge markets (paragraph 17)	Yes	A voluntary hedge price is being finalised and will be published soon. Consumers not directly involved, though officials were directly involved. MEUG acted as a coordinator to inform and get consumer response in liaison with a representative of the retailers and officials that were developing the index.	Almost completed, so EGB would add no value
Development of real time market and promotion of demand-side participation (paragraph 18)	Yes	Trial ex post-indicative real time pricing is about to start. Transpower and NZEM have also agreed a trial to review demand side bidding issues. Consumers not involved in final decisions on either of these (it was NZEM Rules Committee), though consumers involved in NZEM MPWG.	Almost completed, so EGB would add no value
Projections of system adequacy (paragraph 19)	Yes	Understand that Transpower will be publishing a report in the near term	Transpower doing this anyway, so EGB would add no value

Promotion of financial instruments to manage transmission risk (paragraph 20)	Yes	Proposal by Government to implement recommendations in report by Dr Read. Consumers involved in Transpower coordinated FTR Industry Consultation Working Group. Consumers also involved in NZEM MPWG, where rule proposals to expropriate rentals were considered.	Dr Read has suggested EGB be party to facilitate development of regional allocation methodology for FTR auction receipts and residual loss and constraint rentals. Consumers are unlikely to support this as EGB is per EGBL application
Development of transmission service definition measures and levels (paragraphs 21-24 and attachment 1 to GPS)	Yes	Transpower managing process using Part F of rulebook and indicated that need not have EGB in process. Consumers treated equally as generators and distributors in consultation process by Transpower	EGB not needed.
Transmission pricing (paragraphs 21-24 and attachment 1 to GPS)	Yes	Transpower managing process and probably mindful of Commerce Commission thresholds process also. Consumers treated equally as generators and distributors in consultation process by Transpower	Not clear what value an EGB will add to process.
Enforcement of transmission charges (paragraphs 21-24 and attachment 1 to GPS)	Yes	No current work, rather an option available following a change to the Commerce Act last year	Not clear what value an EGB will add to process.
Development of multilateral processes for grid expansion and replacement	Yes	Transpower managing process using Part F of rulebook and indicated that need not have EGB in process. Consumers treated equally as generators and distributors in consultation process by Transpower	EGB not needed.
Model approaches to distribution pricing (paragraph 10 and 25)	No	This is likely to more influenced by: <ul style="list-style-type: none"> • Transpower's pricing methodology becoming a precedent for distributors; and • Thresholds regime examining specific price paths and thereby influencing pricing approaches 	None
Model use of system agreements (paragraph 10 and 25)	No	MARIA Model Distribution Contract Project working on this. There are two consumer representatives on this project and there were several consumer representatives working on the TWG that initiated this work.	Little if any
Terms and conditions for connection of distributed generation (paragraph 10 and 25)	No	MARIA Model Distribution Contract Project working on this. There are two consumer representatives on this project and there were several consumer representatives working on the TWG that initiated this work.	Little if any
Consumer switching protocol (paragraph 25)	No	Being managed by MARIA already – this lacks consumer involvement	EGBL proposal on governance of these rules is virtually

			unchanged so will not improve consumer involvement and therefore perpetuates risk of those with market power controlling rules
Arrangements in the event of retailer insolvency (paragraph 25)	No	No current work that aware of. MEUG have not supported the need for this over and above insolvency laws that apply to any other commodity purchased by consumers.	Not clear what value an EGB will add if any.
Pre-payment meters (paragraph 25)	No	No current work that aware of. MEUG have not supported this because the economic benefits of this policy have never been proven.	Not clear what value an EGB will add if any.
Model domestic retail contract (paragraph 25)	No	No current work that aware of; though in developing model distribution contracts those must take into account what consumers might want downstream.	None.
Consumer complaints resolution system (paragraph 29)	No	A voluntary independent Electricity Consumer Complaints Commissioner has been established with wide support from suppliers. Consumer groups were consulted in the establishment of the Electricity Consumer Complaints Commissioner.	None.

Appendix 4: Cost of Capital

EGBL suggests that a benefit of authorising their arrangement will be that electricity suppliers will have a lower cost of capital compared to that should a Crown Electricity Governance Board (EGB) be established. The differential in cost of capital is due to different regulatory risks being factored in. The draft determination has adjusted the suggested benefit to apply only to private supplier capital at risk.

MEUG submit this approach is incorrect because the direction of any change in cost of capital for all sectors of the economy needs to be considered (not just suppliers) and in that case it is not clear which if any direction the overall cost of capital will change and in our view any change will be immaterial. In support of this conclusion we note the following:

- Governments continuously change the rules in which capital markets and industry specific markets operate. One of the more recent examples of a change that affects all of the New Zealand capital market was the legislative change to allow de-mutualisation of the stock exchange subject to Government agreeing the rules. That very large intervention in the capital market had no change the Market Price Premium for New Zealand that we are aware of. For the applicant to suggest a relatively small industry specific intervention such as triggering the option of a Crown EGB will affect New Zealand's Market risk Premium does not therefore seem plausible.
- Industry specific changes occur all the time but again it would be a brave analyst who could predict what the impact of an industry specific law change would have on the New Zealand aggregate Market Risk Premium.
- Assuming that there is no change in New Zealand's sovereign or country risk as a result of the Government implementing a Crown EGB and therefore no change in the Market Risk Premium, then a shift in the asset beta of any single part of the economy (eg for electricity suppliers) will be offset by a shift in the asset beta of some or all other sectors in the economy (eg manufacturers perceived risks will go down as electricity rules not dominated by suppliers with market power). The overall cost to the New Zealand economy of borrowing from overseas lenders or raising capital from overseas investors will remain unchanged, even though for some sectors the cost of capital may go up and for others those costs will go down.
- Even if the capital markets were as a result of the Government establishing a Crown EGB to increase New Zealand's country risk, then we disagree that the cost of that adjustment would be material or could be assumed to be a permanent feature. Capital markets adjust country risk factors for a range of factors. An adjustment for the specific purpose relating to one particular intervention when the Government every day passes regulations and legislation that constantly changes the boundary between the state and private investors is in our view spurious. Even if the Commission were to try to calculate what the benefit of that country risk factor change in the cost of capital were, there is no surety that future Governments will be as enthusiastic about a Crown EGB (eg the opposition parties did not support the legislation last year) so that there is a likelihood that any Crown EGB formed might equally be dissolved if the composition of the Government changes.
- Any observed change in the expected cost of capital of electricity suppliers may be due to their cost of debt rising as their credit rating falls as markets adjust cash-flow risk to take into account the reduced market power they have. Conversely energy intensive users might find that their cost of debt becomes lower because of the reduced cash-flow risk. In this example the country Market Risk Premium and the asset beta of the supply and end user industries remains unchanged. This illustrates that factors affecting cost of capital are complex and need to be considered across all sectors and the economy as a whole, not just suppliers as the applicant has suggested.