

13 May 2011

Dr Brent Layton  
Chair  
Electricity Authority  
PO Box 10041  
Wellington

Dear Dr Layton

**Draft decision of the Electricity Authority under Part 5 of the Electricity Industry Participation Code regarding an alleged Undesirable Trading Situation on 26 March 2011**

Powershop commends the Authority on its comprehensive analysis of the circumstances surrounding the Undesirable Trading Situation (UTS) on 26 March 2011 and appreciates the opportunity to comment on the draft decision. Powershop's submission is contained in this letter.

We are pleased that the Authority has concluded that the circumstances surrounding 26 March 2011 do constitute a UTS, and that the Authority sees fit to remedy the situation. However, we are concerned that the draft decision does little to address manipulative behaviour as an undesirable practice and that the remedy may establish "target prices" for all generators in similar circumstances in the future. Accordingly, we remain fearful that such manipulations (albeit with lower price outcomes) may become more prevalent in the market, leading to higher and more volatile wholesale energy prices, and in turn prices faced by consumers.

**1. Has the Authority accurately recorded and interpreted all the salient facts in regard to this matter? If not, please detail the inaccuracies.**

Powershop agrees that the salient facts have been considered and acknowledges that the Authority has information available to it that is not generally available to market participants. We broadly agree with the analysis and interpretation of those facts. However, we are concerned that the draft decision concludes that the UTS has arisen as a result of the "perfect storm" of **circumstances** (transmission maintenance, TCC outage and Huntly offers) rather than as a result of the underlying **behaviour** of Genesis Energy.

We also believe some analysis of the loss and constraint rentals on during the event may be relevant. We expect this to show that the pain inflicted on Upper NI consumers and retailers will be disproportionate to the gain of Genesis. This is of concern if Genesis intend to use the spot market to recover the operating costs of Huntly.

**2. Do you agree with the Authority's draft decision that the situation existing on 26 March 2011 constitutes a UTS? Please give reasons for your answer.**

Powershop agrees that the situation existing on 26 March 2011 constitutes a UTS. We concur with the Authority's view that:

*"the events on that day threaten, or may threaten, trading on the wholesale market for electricity and would, or would be likely to, preclude the maintenance of orderly trading or proper settlement of trades (in particular, the events involved the undesirable trading practice of squeezing a market and resulted in an exceptional and unforeseen circumstance that threatens, or may threaten, generally accepted principles of trading and the public interest)"*

We also agree that:

*"the event cannot satisfactorily be resolved by any other mechanism available under the Code."*

However, we continue to hold the view that Genesis engaged in manipulative trading and disagree with the draft decision on this aspect of the UTS.

On the basis that the Authority has more information available to it to analyse these matters, we can accept the Authority's conclusion that:

- (a) there has not been any material breach of any law;
- (b) Genesis' offer strategy regarding its Tokaanu, Rangipo and Tuai power stations is consistent with managing its own risk position, and the analysis does not support the view that Genesis caused transmission constraints to bind.

However, irrespective of the above, and the fact that there was a coincident outage of Contact's Taranaki Combined Cycle plant it is our strong view that the Huntly offers during the period of the transmission outage were deliberate (this does not appear to be in dispute) and constitute manipulation of the circumstances for the commercial gain of Genesis. We find it curious that the Authority has concluded that there was a squeeze in the market while not also concluding that the behaviour of the squeezer (Genesis) was manipulative trading.

Genesis engaged in manipulative behavior by taking advantage of transient market power and applying prices that were grossly detached from underlying supply and demand conditions.

We also support the view that the UTS provisions were included in the code to protect the integrity of the market, and that they should be invoked to preserve the economic validity of prices in the market.

In summary, the Authority's rationale for declaring the event on 26 March 2011 a UTS skims over the deliberate behavior of Genesis which caused a 'squeeze' that resulted in extraordinary prices. We're of the view that the decision should be amended to find that Genesis' behaviour did constitute manipulative trading.

### **Market manipulation**

The draft decision describes Genesis' actions to take advantage of market power arising from the transmission outage and apply prices well above the cost of supply as a 'squeeze'. A squeeze by its very nature is widely regarded as a form of market manipulation<sup>1</sup>. Market manipulation is prohibited in most markets because it is inefficient and destructive.

Genesis took advantage of market power arising from the transmission outage to realise prices well above the cost of supply. As illustrated by the offer stacks included in the paper, Genesis' offer strategy was clearly changed to manipulate its offers to take advantage of the transmission outage. Tranches that were previously priced below \$100 were priced at \$18,000+ for the period of the outage alone. There was no forewarning of the event, Genesis may have placed thousands of offers into the market at \$1000+ but generally this was marginal tranches, they had not previously deployed a strategy where 50% of Huntly's capacity was offered at \$18,000+. Clearly in the face of competitive pressure Genesis would not have been able to achieve such extreme prices.

The Authority needs to make it clear that during times of transient market power, in particular where there are planned transmission outages, that it is unacceptable to exploit that market power by pricing at a level that is not economically valid. This kind of behaviour is unacceptable because productive and dynamic efficiency will be materially reduced as participants are incentivised to find/ create situations that generate 'super' profits. This behavioral dynamic will make the market extremely risky, volatile and unpredictable. It will cause market prices to increase and there will be inefficient signals affecting the timing and location of generation investment. Ultimately this lack of order and efficiency will undermine confidence in the market, the Authority, and cost consumers.

In *Pirrong, Energy Market Manipulation: Definition, Diagnosis and Deterrence, in the Energy Law Journal, 2010* the criteria for diagnosing market manipulation is identified, below we discuss Genesis' behavior against this criteria:

(1) *The price of the manipulated contract was "artificial" (known as "price artificiality")*

An artificial price is one that is created from behaviour rather than underlying demand and supply conditions. Because of the transmission outage Genesis was the net pivotal generator and had the ability to set the price for the upper north island in absence of

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<sup>1</sup> <http://bauer.uh.edu/spirrong/Pirrong-EnergyMarketManipulation-022510.pdf>

usual competitive forces. Genesis priced tranches of their load at levels approximating the value of lost load when they had excess capacity available to meet demand – prices did not reflect underlying demand and supply conditions.

*(2) The accused had the ability to cause the artificial price*

Because of the transmission outage Genesis was the net pivotal generator and was able to set the price in the market on the day.

*(3) The accused caused the price to be artificial*

Genesis was the price setter on 26<sup>th</sup> March, they chose to price their Huntly generation differently to when they faced competition. Throughout the day of the 26<sup>th</sup> they could have revised offers to more realistically approximate market conditions on the day but chose not to.

*(4) The accused acted with intent to cause the price to be artificial*

It's clear from public statements<sup>2</sup> and comments to the Authority that Genesis deliberately acted with intent to cause the extreme prices during the period of the transmission outage.

**3. Do you agree with the draft remedial actions that the Authority intends to take to correct the UTS? Please give reasons for your answer**

Powershop agrees that the remedial action should involve resetting prices to a more appropriate level. However we don't agree with the rationale or methodology proposed for resetting them.

In the analysis it's suggested that with forewarning of a generator attaining a net pivotal position we have 3 options, in practice this is quite unrealistic. As a retailer to the residential market demand response is not a practicable option, and even if it was it would provide limited financial relief because residential customers are settled using the non half-hourly residual market profile (ie. monthly load will be "spread" into the affected trading periods). It's also not possible to build a peaking plant within the usual timeframe of hedge negotiations (6mth – 2y), nor are small retailers in a position to do this, so it's not a credible option or competitive threat. Consequently our only realistic option is to negotiate hedge cover with the net pivotal generator, whose price could include monopoly rents.

We're gravely concerned that the proposed remedy does not discourage abuse of transient market power by a net pivotal generator and instead condones it. Under this methodology net pivotal generators will confidently receive super normal profits when they apply a squeeze. This price signal isn't economically valid because new generation

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<sup>2</sup> <http://www.genesisenergy.co.nz/about-us/news/genesis-energy-rejects-accusation-of-despicable-conduct-by-powershop.cfm>



is not necessary, there is sufficient existing capacity it's simply not exposed to the usual competitive pressure of the market. Investing in new generation to combat a behavioural strategy is not in the long term interests of consumers. It will result in dynamic and productive efficiency reductions.

We accept that it is not the Authority's role to prevent participants from making money, however it is the Authority's role to prevent participants making money through manipulative trading; this is precisely what the UTS rules are intended to protect against. We believe it is appropriate for the Authority to apply general economic theory to the market when competitive forces are at play, however it is equally important to acknowledge when they are not and provide clear expectations of behaviour and outcomes during such circumstances. We recommend that prices be set be set at close to "normal" or "prevailing" levels rather than levels of hypothetical alternative supply or demand response.

In this instance we recommend that final prices replicate the prices that would have ordinarily resulted when competition in the market was not constrained by the planned transmission outage. We suggest that using average prices in the week prior would be an appropriate proxy, or using Huntly offers from days in close proximity to 26 March (such as the day before, or after, or the following Saturday) to clear the market.

We also strongly recommend that the Authority immediately undertake thorough investigation of possible code changes to curb abuse of transient market power, particularly during planned transmission outages.

Please contact me if you have any questions about this submission.

Yours sincerely,

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