

Consultation Paper

Review of the Undesirable Trading Situation provisions in the Code

Prepared by the Electricity Authority

18 March 2013

Executive summary

The Electricity Authority (Authority) has reviewed the undesirable trading situation (UTS) provisions in the Electricity Industry Participation Code 2010 (Code) in light of recent experience. This review has not identified a need for any fundamental changes, but has highlighted a number of areas where the Code could be improved. These are:

- The definition of a UTS is unclear in some respects.
- There is currently no time limit on how far into the past the Authority may initiate a UTS investigation. This detracts from industry certainty because final prices may be republished as part of a UTS remedy.
- The remedy provisions are unclear in some respects, and could impede the adoption of the most efficient UTS remedy at times.

The Authority is proposing a number of Code amendments to address these issues. These have been developed by considering whether each change is likely to promote efficiency. The Authority has also used the New Zealand Electricity Market (NZEM) provisions relating to undesirable situations as a point of comparison. The NZEM provisions were the outcome of a multilateral negotiation among industry participants at the time they were introduced. They therefore presumably reflect a reasonably balanced set of arrangements in relation to the powers of a market operator to remedy a UTS.

UTS definition

The Authority is proposing a number of changes in relation to the UTS definition. The first is to clarify the scope of markets that can give rise to a UTS. The existing Code confines a UTS to any contingency or event “that threatens, or may threaten, trading on the *wholesale market* for electricity” (emphasis added),¹ but the italicised term is not defined.

The Authority proposes that the definition of “wholesale market” be clarified to mean the spot market for electricity, markets for ancillary services and the hedge market for electricity. This definition is consistent with the interpretation commonly used in the industry and suggested by the High Court in its judgment in relation to the UTS on 26 March 2011.²

The second change is to refocus the UTS definition around the core concern from a policy perspective (maintenance of wholesale market confidence and integrity),

¹ There are also other requirements to meet the UTS test.

² In that these definitions generally include the spot market and hedge market as part of the wholesale market.

rather than intermediate processes (trading and settlement). This would make it clear that a situation cannot be a UTS unless it threatens, or may threaten, confidence in, or the integrity of, the wholesale market. It is also proposed that the definition should utilise the term “situation” rather than “contingency or event” to describe the condition which could give rise to a UTS.

The final definitional change is to remove the examples of possible undesirable trading situations in clause (c) of Part 1 of the Code, and relocate them in Part 5 of the Code. This would align with the recent High Court decision on how the examples in clause (c) should be interpreted, and remove any scope for uncertainty on this issue.

Finally, a consequential change is proposed to clause 13.255 of the Code which allows the Authority to suspend FTR allocations in some circumstances. This change is proposed to make clause 13.255 consistent with the modified UTS provisions.

The Authority considers that the proposed amendments would improve clarity in relation to UTS provisions. It would also bring the Code closer to the NZEM definition of an undesirable situation. That said, the Authority proposes to retain the current Code provision that requires that a situation will not be a UTS if in the reasonable opinion of the Authority, it can satisfactorily be resolved by any other mechanism available under the Code. This would ensure that the UTS provisions remain as a residual power, and cannot be exercised where the Code satisfactorily deals with an issue.

UTS processes

The Authority is proposing to introduce a time limit for triggering a UTS investigation. This would preclude an investigation being initiated if an alleged undesirable trading situation commenced more than ten business days in the past. This provision should increase overall certainty for participants by removing the (albeit remote) potential for UTS provisions to be used to address issues (and reopen final prices) well after a UTS has occurred. This safeguard was not included in the NZEM Rules.

UTS remedies

The Authority is proposing two key changes in relation to UTS remedies. First, it is seeking to clarify the parts of the electricity industry in which a UTS remedy may be applied. At present the Code provides for the Authority to take steps “in relation to the wholesale market”, but it is not clear whether this means only steps that ‘affect’ the wholesale market, or that are ‘within’ the wholesale market. The Authority proposes to clarify this by permitting remedial directions to be issued, provided they relate to an aspect of the electricity industry that the Authority could regulate in the Code under section 32 of the Electricity Industry Act (Act). The second proposed change is to

remove the requirement for any such directions to be “not inconsistent with this Code”.

This approach is comparable with the NZEM Rules which provided the Market Surveillance Committee with very broad powers to correct an undesirable situation. Furthermore, the Authority notes that its decision-making powers are subject to review under administrative law, which is an additional protection as compared to the NZEM Rules. |

Glossary of abbreviations and terms

Authority	Electricity Authority
Act	Electricity Industry Act 2010
Code	Electricity Industry Participation Code 2010
NZEM	New Zealand Electricity Market
UTS	Undesirable trading situation

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1. Introduction and purpose of this paper

1.1 Introduction

1.1.1 The Board of the Electricity Authority (Authority) has decided to review the undesirable trading situation (UTS) provisions in the Electricity Industry Participation Code 2010 (Code) in light of certain, predominantly technical, issues regarding the drafting that were identified during the investigation into whether the events of 26 March 2011 constituted a UTS. This review also takes account of comments by the High Court in relation to the drafting of the current UTS provisions.³

1.2 Purpose of this paper

1.2.1 The purpose of this paper is to consult with participants and persons that the Authority thinks are representative of the interests of persons likely to be affected by the Code amendment proposal contained within, which relates to proposed changes to the UTS provisions in the Code.

1.2.2 Section 39(1)(c) of the Electricity Industry Act 2010 (Act) requires the Authority to consult on any proposed amendment to the Code. The Act also requires the Authority to prepare and publish a regulatory statement that must include a statement of the objectives of the proposed amendment, an evaluation of the costs and benefits of the proposed amendment, and an evaluation of alternative means of achieving the objectives of the proposed amendment. The regulatory statement is set out in part 3 of this paper.

1.2.3 The proposed amendment is attached as Appendix 2.

1.2.4 The Authority invites submissions on the regulatory statement and the proposed amendment, including drafting comments.

1.3 Submissions

The Authority's preference is to receive submissions in electronic format (Microsoft Word). It is not necessary to send hard copies of submissions to the Authority, unless it is not possible to do so electronically. Submissions in electronic form should be emailed to submissions@ea.govt.nz with Consultation Paper—Review of the Undesirable Trading Situation provisions in the Code in the subject line.

³ Bay of Plenty Energy Limited v Electricity Authority [2012] NZHC 238

If submitters do not wish to send their submission electronically, they should post one hard copy of their submission to either of the addresses provided below.

Submissions
Electricity Authority
PO Box 10041
Wellington 6143

Submissions
Electricity Authority
Level 7, ASB Bank Tower
2 Hunter Street
Wellington

Tel: 0-4-460 8860

Fax: 0-4-460 8879

- 1.3.1 Submissions should be received by 5:00pm on Wednesday 1 May 2013. Please note that late submissions are unlikely to be considered.
- 1.3.2 The Authority will acknowledge receipt of all submissions electronically. Please contact the Submissions Administrator if you do not receive electronic acknowledgement of your submission within two business days.
- 1.3.3 If possible, submissions should be provided in the format shown in Appendix 1. Your submission is likely to be made available to the general public on the Authority's website. Submitters should indicate any documents attached, in support of the submission, in a covering letter and clearly indicate any information that is provided to the Authority on a confidential basis. However, all information provided to the Authority is subject to the Official Information Act 1982.

2. Background

2.1 Economic rationale for UTS provisions

- 2.1.1 The economic rationale for UTS provisions is to achieve operationally efficient and competitive markets. In voluntary marketplaces, market providers strive to attract buyers and sellers by adopting rules that promote operationally efficient trading and rules aimed at giving buyers and sellers confidence in the market.
- 2.1.2 In particular, market providers adopt rules aimed at giving buyers confidence that suppliers' goods and services are what they say they are, contract terms are transparent, and prices are competitively determined. Likewise, market providers adopt rules aimed at giving sellers confidence that buyers are genuine and will meet their payment terms. Undesirable practices by a few buyers and sellers harm other market users, and they also harm the market provider by deterring some parties from using the market. Undesirable situations may also arise due to unanticipated external factors.
- 2.1.3 UTS provisions are adopted by market providers because they cannot foresee all future eventualities and hence explicitly cater for these in the market's rules. Also, some practices are particularly difficult to specify in the rules, and so are better covered by generic UTS-type provisions.
- 2.1.4 As market providers have strong incentives to enforce UTS provisions to further the efficient operation of the market and build confidence in it, UTS provisions often give broad discretion to market providers to deal with practices that threaten trading and settlement on the market in some manner. Having the ability in certain circumstances to constrain the commercial decisions or actions of market participants is common to most organised markets.

2.2 Link between the current UTS provisions and the Authority's statutory objective

- 2.2.1 The Authority's statutory objective is set out in section 15 of the Act as follows:

The objective of the Authority is to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.

- 2.2.2 The Authority interprets its statutory objective as requiring it to exercise its functions set out in section 16 of the Act in ways that, *for the long-term benefit of electricity consumers*:
- (a) facilitate or encourage increased competition in the markets for electricity and electricity-related services, taking into account long-term opportunities and incentives for efficient entry, exit, investment and innovation in those markets (limb 1);
 - (b) encourage industry participants to efficiently develop and operate the electricity system to manage security and reliability in ways that minimise total costs whilst being robust to adverse events (limb 2);
and
 - (c) increase the efficiency of the electricity industry, taking into account the transaction costs of market arrangements and the administration and compliance costs of regulation, and taking into account Commerce Act 1986 implications for the non-competitive parts of the electricity industry,⁴ particularly in regard to preserving efficient incentives for investment and innovation (limb 3).
- 2.2.3 Based on the general economic rationale given above, the presence of a UTS provision in the Code is judged to be consistent with facilitating and encouraging competition (limb 1 of the Authority's statutory objective) and especially increasing the efficiency of the electricity industry (limb 3).

⁴ This refers to those parts of the electricity industry that are regulated under Part 4 of the Commerce Act.

3. Regulatory Statement

3.1 Authority's proposal

3.1.1 This section sets out proposed improvements to the UTS provisions under the following categorisations:

- (a) the definition of a UTS
- (b) the processes set out in the Code in regard to a potential or actual UTS
- (c) the remedies available to the Authority when a UTS has occurred.

UTS definition

Which specific electricity markets should be subject to the UTS provisions?

3.1.2 The current definition of a UTS limits the UTS provisions to events or contingencies that threaten, or may threaten, trading on the "**wholesale market for electricity**". However, it is unclear what exactly is meant by the wholesale market for electricity. It would be desirable if the Code was clear as to which parts of the electricity industry are subject to a possible UTS determination.

3.1.3 Since the industry reforms in the early to mid 1990s, the wholesale market for electricity in New Zealand has generally been seen as consisting of the spot and bilateral contracting physical markets, and the financial hedge market. For example, in its July 2001 decision on a claimed undesirable situation,⁵ the New Zealand Electricity Market (NZEM) Market Surveillance Committee stated:

"There are a number of markets for electricity in New Zealand. These include the bi-lateral physical market (reconciled through MARIA), the "spot market" (administered by NZEM), the financial hedge market (these three markets comprising the wholesale market) and the retail market".⁶

3.1.4 This definition of the wholesale market is consistent with the High Court decision in relation to the UTS on 26 March 2011. In that judgment, the High Court stated:

⁵ The term that is contained in the NZEM rules which corresponds to a UTS.

⁶ *Claimed Undesirable Situation arising from high spot prices in May / June 2001*, Market Surveillance Committee memorandum, page 6, 17 July 2001

“The wholesale market for electricity consists essentially of the spot market and the hedge market”.⁷

- 3.1.5 From a policy perspective, the Authority agrees that the “spot market” should fall within the definition of wholesale market. To take any other approach would effectively render the UTS provisions inoperative. Furthermore, the Authority considers that it would be desirable to explicitly include ancillary service markets within the wholesale market definition, given that these services are fundamental to the orderly operation of the wholesale market for electrical energy.
- 3.1.6 Turning to financial hedge products,⁸ on the one hand an argument can be raised that the Authority should not be able to find that a UTS exists in a part of the market that operates predominantly outside the Code. While some elements of the financial hedge market are subject to the Code (hedge disclosure requirements, the ability of participants to settle hedges via the clearing manager, and financial transmission rights), the Code does not govern this market to the same extent as it does the wholesale spot market for energy and ancillary service markets.
- 3.1.7 On the other hand, section 42 of the Act required the Authority to facilitate, or provide for, an active market for trading financial hedge contracts for electricity. The Authority met this statutory requirement via market facilitation measures rather than via the Code. However, this approach does not remove the Authority’s responsibility to facilitate or provide for an active financial hedge market for electricity, and that this market is developed and operates in accordance with the Authority’s statutory objective.
- 3.1.8 Furthermore, if the hedge market were to be excluded when determining whether the UTS provisions apply, the Authority’s focus would be confined to conditions in the spot and ancillary service markets. Arguably, this would mean that the Authority could not take into account matters such as the potential ‘stabilising’ influence that the hedge market has within the wider wholesale market.
- 3.1.9 In light of these factors, the Authority considers that the definition of the wholesale market should explicitly encompass the spot market for electricity, the ancillary service markets and the hedge market.

⁷ *Bay of Plenty Energy v Electricity Authority* [2012] NZHC 238, paragraph 16.

⁸ In this context, hedge products means instruments to mitigate exposure to spot price risk, such as bilaterally negotiated ‘over the counter’ contracts, exchange traded products such as futures and options contracts, and financial transmission rights.

- 3.1.10 For completeness, the Authority notes that this definition would also have application in relation to proposed amendments to clause 13.2 of the Code which relate to information disclosure obligations for participants.

Authority's proposal

- 3.1.11 It is proposed that the definition of “wholesale market” in Part 1 be amended to:

wholesale market means ~~the wholesale market for electricity~~—

(a) the spot market for **electricity**, including the process for setting—

(i) **real time prices:**

(ii) **forecast prices and forecast reserve prices:**

(iii) **provisional prices and provisional reserve prices:**

(iv) **interim prices and interim reserve prices:**

(v) **final prices and final reserve prices:**

(b) markets for **ancillary services:**

(c) the hedge market for **electricity**, including the market for **FTRs**

- 3.1.12 The term “wholesale market” is also used in clauses 9.14(2)(a), 13.236E(1)(f), and 13.263E(4)(b) of the Code. These clauses all appropriately relate to the new definition of “wholesale market”, and hence no amendments to these clauses are considered necessary.

Q1. Do you agree with the proposal that the current definition of “wholesale market” should be clarified as including the spot market for electricity, the ancillary services markets and the hedge market?

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority’s statutory objective in section 15 of the Act.

What can be categorised as a UTS?

3.1.13 The Code currently defines a UTS as:

any contingency or event:

- (a) *that threatens, or may threaten, trading on the **wholesale market** for **electricity** and that would, or would be likely to, preclude the maintenance of orderly trading or proper settlement of trades; and*
- (b) *that, in the reasonable opinion of the **Authority**, cannot satisfactorily be resolved by any other mechanism available under this Code; and*
- (c) *includes, without limitation,—*
 - (i) *manipulative or attempted manipulative trading activity; and*
 - (ii) *conduct in relation to trading that is misleading or deceptive, or likely to mislead or deceive; and*
 - (iii) *unwarranted speculation or an undesirable practice; and*
 - (iv) *material breach of any law; and*
 - (v) *any exceptional or unforeseen circumstance that is at variance with, or that threatens or may threaten, generally accepted principles of trading or the public interest.*

3.1.14 In its decision on the UTS on 26 March 2011, the Authority interpreted the definition of a UTS as always requiring that (a) and (b) be established. It further concluded that although the examples in (c) can be a UTS, they would only be a UTS if those factors in (a) and (b) were also present.⁹

3.1.15 The High Court supported the Authority's interpretation of the inter-relationship between clauses (a), (b) and (c), but stated:

“The definition of a UTS is not without its difficulties”.¹⁰

3.1.16 In particular, the High Court stated:

“subclause (c)(v) is particularly problematic. It confusingly uses different terminology relating to trading than clause (a) (“orderly” in clause (a) and “accepted principles” in clause (c)). It is not clear whether they are intended to be equivalent or different and if different, how. As I have previously noted, clause (c) uses the standard of proof “may” where clause (a) uses the standard “likely” in relation to assessing whether these trading

⁹ *Final decision on the Undesirable Trading Situation of 26 March 2011*, Electricity Authority, 4 July 2011, paragraphs 15 – 19

¹⁰ *Bay of Plenty Energy v Electricity Authority* [2012] NZHC 238, paragraph 130

standards (accepted principles or orderly) have been threatened or precluded”.¹¹

3.1.17 The High Court went on to state:

“a better approach in the future may be for the Authority to focus solely on whether clauses (a) and (b) are established, accepting that the circumstances in clause (c) may give an indication to the market and the Authority about the types of circumstances that might be a UTS”.¹²

3.1.18 In light of experience, the Authority proposes a number of changes to the UTS definition.

Frame around maintenance of wholesale market confidence and integrity

3.1.19 The Authority considers that it would be preferable to frame the UTS definition around the core concern from a policy perspective (maintenance of wholesale market confidence and integrity), rather than intermediate processes (trading and settlement).

3.1.20 This would make it clear that a situation cannot be a UTS unless it threatens, or may threaten, confidence in, or the integrity of, the wholesale market.¹³ By contrast, under the current Code the Authority and participants must decide what is meant by “threatens, or may threaten, trading on the wholesale market for electricity and that would, or would be likely to, preclude the maintenance of orderly trading or proper settlement of trades”.

3.1.21 There was significant debate about the meaning of these provisions in relation to the UTS on 26 March 2011. Some parties argued that the provisions should be interpreted in a narrow sense, for example whether trading could continue or not. The Authority maintained that the UTS definition should be considered against the statutory objective in the Act, including the effects on market confidence. While the High Court ultimately found that the Authority had correctly applied the law in this area,¹⁴ the Authority considers that a definition framed around the core policy concern would reduce future uncertainty.

¹¹ *Bay of Plenty Energy v Electricity Authority* [2012] NZHC 238, paragraph 139

¹² *Bay of Plenty Energy v Electricity Authority* [2012] NZHC 238, paragraph 140

¹³ This is not the only pre-condition, as set out below.

¹⁴ *Bay of Plenty Energy v Electricity Authority* [2012] NZHC 238, paragraphs 201 - 220

Use of “situation” rather than “contingency or event”

- 3.1.22 The Code currently defines a UTS as “any contingency or event” which meets a number of tests. Given that the UTS provisions are focussed on “undesirable trading **situations**” (emphasis added), it is not clear why the definition is framed in terms of a “contingency or event”.
- 3.1.23 The Authority notes that the equivalent NZEM provision referred to the “situation” concept, and this is regarded as the preferable approach. Accordingly, the Authority proposes that references in the definition (and elsewhere) to “contingency or event” would be replaced by “situation.”

UTS examples in clause (c)

- 3.1.24 The Authority proposes that the examples in paragraph (c) of the UTS definition be removed from Part 1 of the Code. Instead, they would be listed in Part 5 of the Code as examples of possible situations that could give rise to a UTS. The examples are largely the same as the current Code, except for (c)(v) which has been simplified by removing the differing terminology from (a), which the High Court referred to as confusing. The removal of (c) from Part 1 would make it clear that a situation is only a UTS if it meets (a) and (b).

Authority’s proposal

- 3.1.25 It is proposed the definition of a UTS in Part 1 be amended to:

undesirable trading situation means any situation ~~contingency or event~~

- (a) *that threatens, or may threaten, confidence in, or the integrity of, trading on the wholesale market for electricity and that would, or would be likely to, preclude the maintenance of orderly trading or proper settlement of trades; and*
- (b) *that, in the reasonable opinion of the **Authority**, cannot satisfactorily be resolved by any other mechanism available under this Code; and*
- ~~(c) includes, without limitation, —~~
- ~~(i) manipulative or attempted manipulative trading activity; and~~
- ~~(ii) conduct in relation to trading that is misleading or deceptive, or likely to mislead or deceive; and~~
- ~~(iii) unwarranted speculation or an undesirable practice; and~~
- ~~(iv) material breach of any law; and~~
- ~~(v) any exceptional or unforeseen circumstance that is at variance~~

~~with, or that threatens or may threaten, generally accepted principles of trading or the public interest~~

3.1.26 It is proposed that the following provisions be added to clause 5.1 of the Code:

(2) The following are examples of what the **Authority** may consider to constitute an **undesirable trading situation**:

(a) manipulative or attempted manipulative trading activity:

(b) conduct in relation to trading that is misleading or deceptive, or is likely to mislead or deceive:

(c) unwarranted speculation or an undesirable practice:

(d) material breach of any law:

(e) a situation that threatens orderly trading or proper settlement:

(f) any exceptional or unforeseen circumstance that is contrary to the public interest.

(3) To avoid doubt—

(a) the list of examples in subclause (2) is not an exhaustive list, and does not prevent the **Authority** from finding that an **undesirable trading situation** is developing or has developed in other circumstances; and

(b) an example listed in subclause (2) does not constitute an **undesirable trading situation** unless the example comes within the definition of that term in Part 1.

Q2. Do you agree with the proposed changes to Part 1 of the Code to clarify the definition of a UTS?

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority’s statutory objective in section 15 of the Act.

Q3. Do you agree that the examples in paragraph (c) of the current definition of a UTS should be retained in the Code, and moved to Part 5?

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority’s statutory objective in section 15 of the Act.

Suspension of allocation of financial transmission rights

3.1.27 Clause 13.255 of the Code allows the Authority to direct the FTR manager to suspend the allocation of FTRs “if there is any contingency or event that:

- (a) threatens or threatens, or may threaten, the allocation or settlement of FTRs and that would, or would be likely to, preclude the maintenance of orderly allocation or trading of FTRs or proper settlement of FTRs; and
- (b) that, in the reasonable opinion of the Authority, cannot satisfactorily be resolved by any other mechanism available under this Code.”

3.1.28 This clause is based on the existing UTS provisions, and will not fully align with the proposed UTS amendments, assuming they come into effect.

3.1.29 To limit the scope for any inconsistency to arise, one option would be to delete clause 13.255 altogether. However, this would remove the ability to temporarily suspend FTR allocations unless the situation constituted a UTS. This would be unduly restrictive, given that circumstances could credibly arise in the FTR market that justify a temporary suspension (especially as this market is new), but which fall short of being a UTS.

3.1.30 Given that the Authority sees merit in maintaining a suspension provision that is specific to the FTR market, it proposes to amend clause 13.255 as follows:

13.255 Authority may direct FTR manager to suspend allocation of FTRs

The Authority may direct the FTR manager to suspend the allocation of FTRs if there is any situation ~~contingency or event~~ that—

- (a) *threatens, or may threaten, confidence in, or the integrity of, the allocation or settlement of FTRs ~~and that would, or would be likely to, preclude the maintenance of orderly allocation or trading of FTRs or proper settlement of FTRs;~~ and*
- (b) *~~that,~~ in the reasonable opinion of the Authority, cannot satisfactorily be resolved by any other mechanism available under this Code.*

Q4. Do you agree with the proposed changes to clause 13.255 of the Code to align it with the suggested changes to UTS provisions?

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority's statutory objective in section 15 of the Act.

UTS processes

- 3.1.31 The Code includes specific processes to be followed by the Authority when considering a UTS. These include a requirement for the Authority to consult (if practical) on actions it intends to take to correct a UTS. The Authority considers this provision to be important and no change is proposed in this area. The Authority also notes that its actions in relation to the conduct of a UTS investigation are subject to general administrative law principles.
- 3.1.32 The only area where the Authority is proposing a change to UTS processes is in relation to a time limit on the ability to initiate a UTS investigation.

Time limit on initiating a UTS investigation

- 3.1.33 An issue handed over to the Authority by the Electricity Commission was the question of whether there should be a time limit for changing final prices in the event of a UTS and/or for claiming a UTS.
- 3.1.34 In the Electricity Commission's 2010 review of UTS provisions, some parties submitted that there should be a time limit on the ability to republish final prices in response to a UTS. Key reasons put forward for this included ensuring the integrity of historic prices, limiting uncertainties faced by participants with commercial hedge arrangements and giving finality to the market.¹⁵
- 3.1.35 The same generic issue arose when the Electricity Commission changed the rule that precluded the republication of final prices, notwithstanding the existence of a UTS. Submitters generally agreed that this prohibition needed to be removed, but requested that the Electricity Commission consider a time limit on the republication of final prices. In light of participant views, the Authority placed this matter on its work programme for 2012/13.

¹⁵ Refer <http://www.ea.govt.nz/our-work/consultations/wholesale/uts-provisions/submissions/>.

- 3.1.36 Having assessed the issue, the Authority agrees that an open-ended time limit on the republication of final prices is undesirable from the perspective of promoting market certainty. On the other hand, it is important to ensure that any time limit should not unreasonably constrain the Authority's ability to give proper consideration to UTS claims and (if relevant) take corrective actions including the republication of final prices.
- 3.1.37 In the light of these factors, the Authority considers that a time limit should be introduced that applies to the period between the commencement or discovery of an alleged UTS, and the first consideration of that alleged UTS by the Authority. This would mean that final prices could not be republished once the time limit has passed.
- 3.1.38 A limit which commenced from discovery of an alleged UTS would be consistent with the approach in the Commerce Act,¹⁶ and would allow for remedies to be applied where a UTS occurred in the past, but was not discovered until a later date. However, this approach would mean that there is some possibility (albeit remote) that the UTS provisions could be used to reopen final prices many months or even years after the causative situations occurred. This would be in tension with the objective of promoting certainty in relation to final prices.
- 3.1.39 For this reason, the Authority considers that it is more appropriate for the time limit on initiating a UTS investigation to start from the date that an alleged UTS commenced. This would mean that the UTS provisions could not be triggered if a UTS was first discovered after the time limit expired. While a scenario of this type cannot entirely be ruled out, it appears very unlikely that a situation which threatens or may threaten confidence in, or the integrity of, the wholesale market, could go unnoticed for a long period.
- 3.1.40 It is important to note that the Authority is not proposing that there would be a time limit on the republication of final prices per se, as that would be problematic given the practical uncertainties about the time that could be required for the Authority to complete a UTS investigation, determine remedies (if appropriate), and for any challenges to be resolved through the Courts.
- 3.1.41 In regard to the actual time limit to apply for initiating an investigation after an alleged UTS commenced, the primary consideration here is the trade-off between providing industry participants with certainty over the finality of market outcomes versus ensuring the integrity of the market is protected. As noted earlier, a UTS is by definition a situation that has, or may have,

¹⁶ Section 103(5) provides that "proceedings for an offence against subsection (4) may be commenced within 6 months after the matter giving rise to the contravention was discovered or ought reasonably to have been discovered"

very serious consequences for the wholesale market. Hence, correcting a UTS is important relative to the objective of preserving the ‘finality’ of market outcomes that have occurred (such as amending the level of published final market prices).

3.1.42 However, practically speaking, any situation that meets the test of being a UTS is extremely unlikely to go unnoticed for any extended period. All of the UTS claims lodged under the Electricity Governance Regulations 2003, and as far as the Authority is aware before that under the NZEM rules, were lodged within hours or days of the relevant triggering contingency or event.

3.1.43 In light of these factors, the Authority proposes that a maximum time limit of 10 business days be placed on the period between an alleged UTS commencing, and any subsequent UTS investigation being initiated.

Authority’s proposal

3.1.44 It is proposed the UTS provisions be amended to include:

5.1A Time limit for investigating undesirable trading situation

*Despite clause 5.1(1), the Authority must not commence an investigation if 10 **business days** or more have passed since the situation, which the Authority suspects or anticipates may be an **undesirable trading situation**, occurred.*

<p>Q5.</p>	<p>Do you agree with the proposal that there should be a restriction on the Authority initiating a UTS investigation for situations earlier than a defined time limit in the past?</p> <p>If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority’s statutory objective in section 15 of the Act.</p>
<p>Q6.</p>	<p>Do you agree with the proposal that the time limit should be no more than 10 business days, and apply between the commencement of the alleged UTS and the date the Authority initiates an investigation?</p> <p>If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority’s statutory objective in section 15 of the Act.</p>
<p>Q7.</p>	<p>Do you agree with the proposal that there should be no time limit on republication of final prices per se?</p>

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority's statutory objective in section 15 of the Act.

UTS remedies

3.1.45 A list of the steps the Authority may take to correct a UTS is set out in clause 5.2(2) of the Code.

5.2 Actions Authority may take to correct undesirable trading situation

- (1) *If the **Authority** finds that an **undesirable trading situation** is developing or has developed, it may take any of the steps listed in subclause (2) in relation to the **wholesale market** that the **Authority** considers are necessary to correct the **undesirable trading situation**.*
- (2) *The steps that the **Authority** may take include any 1 or more of the following:*
 - (a) *suspending, or limiting or curtailing, an activity on the **wholesale market**, either generally or for a specified period:*
 - (b) *deferring completion of trades for a specified period:*
 - (c) *directing that any trades be closed out or settled at a specified price:*
 - (d) *giving directions to a **participant** to act in a manner (not inconsistent with this Code, the **Act**, or any other law) that will, in the **Authority's** opinion, correct or assist in overcoming the **undesirable trading situation**.*
- (3) *The **participant** must comply promptly with a direction given to it in writing.*
- (4) *Neither a **participant** nor the **Authority** is liable to any other **participant** in relation to the taking of an action, or an omission, that is reasonably necessary for compliance with an **Authority** direction under this clause.*

Parts of the electricity industry in which UTS remedies may be applied

3.1.46 Under the current Code, to correct a UTS the Authority must take steps "in relation to the wholesale market", but it is not clear whether this means only steps that 'affect' the wholesale market, or that are 'within' the

wholesale market. This lack of clarity affects the scope of directions that the Authority can issue to remedy a UTS.

- 3.1.47 The Authority proposes to clarify this ambiguity by permitting remedial directions to be issued, provided they relate to an aspect of the electricity industry that could be regulated in the Code under section 32 of the Act. The Authority notes that it would still be a requirement for a UTS to occur within the wholesale market (as per the proposed UTS definition above).
- 3.1.48 However, the remedy might require action within or outside the wholesale market. For example, a situation might occur in the metering segment of the industry that resulted in the widespread loss of data. If the situation was sufficiently severe, this might threaten confidence in, or the integrity of, the wholesale market and trigger a UTS. In this example, the preferred remedy might involve some action in the metering area to correct the UTS in the wholesale market, but this might not be possible if the scope of remedies were to be confined to the wholesale market.
- 3.1.49 The proposed approach would allow the Authority to identify the preferred response within the statutory bounds, and apply that to correct the UTS.

Remedies that are inconsistent with the Code

- 3.1.50 Clause 5.2(2)(d) provides that the Authority may give directions to an industry participant to act in a way that will correct or assist in overcoming the UTS. However, any such direction must not be inconsistent with the Code.
- 3.1.51 The Authority notes there may be instances where it is desirable to take steps to resolve a UTS that are inconsistent with the Code. Practically speaking this will manifest itself in either or both of:
- (a) the Authority needing to give directions that might be technically inconsistent with the Code; and/or
 - (b) an industry participant being required to breach certain Code provisions in order to comply with the Authority's direction.
- 3.1.52 Implementation of the 26 March 2011 UTS decision provided an example of this. In preparing to implement this decision, the Authority found that the Code provisions relating to the pricing, clearing and settlement processes are unworkable in dealing with a delay to the publication of final prices, particularly over multiple billing periods. For example, the Code provisions relating to invoicing, the calculation of constrained on amounts, assessment of prudential security, and conducting wash-ups, only provide standard time periods for the clearing and settlement of trades. No provision is made for extended time periods in the event of a UTS

investigation. A further difficulty is that the Code currently makes no provision for the implementation of a “specified” price set by the Authority to correct a UTS, as opposed to “interim” and “final” prices.

3.1.53 In the case of the 26 March 2011 UTS decision, the Authority granted exemptions to the pricing manager and clearing manager in respect of the time periods set out in the Code to assist with the implementation of the UTS decision. In principle, the Authority could also have utilised its power to make urgent Code changes to address these sorts of issues.

3.1.54 However, both exemptions and urgent Code changes are indirect means of ensuring that participants acting on an Authority direction to remedy a UTS will be in compliance with the Code. Accordingly, participants may have some residual doubt about liability. The process of considering exemptions or urgent Code changes alongside UTS remedies would also add cost and complexity for the Authority and participants, as they need to understand how the different mechanisms would interact.

3.1.55 Based on its experience with implementing the UTS decision in regard to the events of 26 March 2011, the Authority is concerned that the current drafting of clause 5.2 of the Code may:

- (a) hinder the Authority in taking the most appropriate action to address a UTS;
- (b) give an ‘unwilling’ participant a possible legal avenue for refusing to comply with an Authority direction to remedy a UTS; and
- (c) leave a participant with real or perceived residual risk of a breach allegation when it is complying with an Authority direction to remedy a UTS.¹⁷

3.1.56 It is proposed that industry participants following directions from the Authority should not face the risk of breaching the Code as a consequence of doing so.

3.1.57 For these reasons, the Authority considers that clause 5.2 should be amended to allow the Authority to give directions that are inconsistent with the Code, provided these are not inconsistent with the Act or any other law.

¹⁷ Although the Authority has the power to decline to pursue a breach if it decides that no further action is warranted, there is nevertheless a regulatory risk for the party concerned. While the Authority also has the ability to grant an industry participant an exemption from complying with the Code, and can do so within three days, the exemption avenue adds cost and complexity to the process of resolving a UTS as quickly as possible.

Authority's proposal

3.1.58 It is proposed the UTS provisions be amended to:

5.2 Actions Authority may take to correct undesirable trading situation

- (1) If the **Authority** finds that an **undesirable trading situation** is developing or has developed, it may take any ~~of the action steps listed in subclause (2) in relation to the **wholesale market** that—~~
- (a) the **Authority** considers *is* are necessary to correct the **undesirable trading situation**; and
- (b) relates to an aspect of the **electricity** industry that the **Authority** could regulate in this Code under section 32 of the **Act**.
- (2) The ~~actions steps~~ that the **Authority** may take under subclause (1) include any 1 or more of the following:
- (a) ~~directing that suspending, or limiting or curtailing, an activity on the **wholesale market**, be suspended, limited or stopped, either generally or for a specified period:~~
- (b) directing that deferring completion of trades *be deferred* for a specified period:
- (c) directing that any trades be closed out or settled at a specified price:
- (d) ~~giving directions to directing a **participant** to take any actions act in a manner (not inconsistent with this Code, the **Act**, or any other law) that will, in the **Authority's** opinion, correct or assist in overcoming the **undesirable trading situation**.~~
- (2A) A direction given to a **participant** under subclause (2)(d)—
- (a) may be inconsistent with this Code; but
- (b) must not be inconsistent with the **Act**, or any other law.
- (3) The **participant** must comply promptly with a direction given to it in writing.
- (4) ~~Neither a **participant** nor the **Authority** is *not* liable to any other **participant** in relation to the taking of an action, or an omission, that is reasonably necessary for compliance with an **Authority** direction under this clause.~~
- (5) A **participant** does not breach this Code if it acts in accordance with a direction given under subclause (2)(d).

<p>Q8.</p>	<p>Do you agree with the proposal that the Authority should be able to take any action to remedy a UTS, provided the action relates to an</p>
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aspect of the electricity industry that the Authority could regulate in the Code under section 32 of the Act?

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority's statutory objective in section 15 of the Act.

Q9. Do you agree with the proposal that industry participants following directions from the Authority do not face the risk of breaching the Code as a consequence of doing so?

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority's statutory objective in section 15 of the Act.

3.2 Statement of the objectives of the proposed amendment

3.2.1 The objectives of the proposed amendment are to:

- (a) improve clarity about the definition of a UTS;
- (b) reduce uncertainty in relation to the finality of published settlement prices; and
- (c) improve the efficiency of the remedies available to the Authority when a UTS has occurred.

3.3 Evaluation of the costs and benefits of the proposed amendment

3.3.1 This section analyses the costs and benefits of the proposed amendment to the UTS provisions in the Code.

Framework for analysis

3.3.2 The analysis treats the current arrangements as the counterfactual, since they will remain in place if no Code amendment is made.

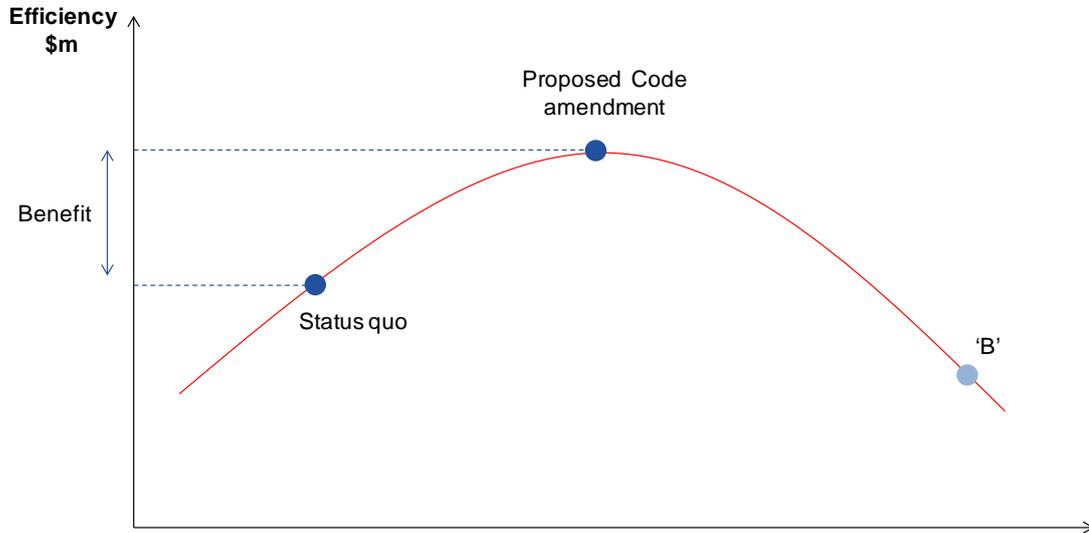
3.3.3 The principal expected benefits of the amendment are reduced uncertainty about the scope of UTS provisions, improved certainty regarding final prices, and more efficient remedies available to the Authority when a UTS has occurred.

- 3.3.4 These in turn are expected to promote dynamic efficiency by providing parties with greater confidence to:
- (a) invest in, and participate in the markets comprising the wholesale market; and/or
 - (b) make investments that rely on electricity as a productive input.
- 3.3.5 This greater confidence arises because parties will be less concerned about factors that could unexpectedly threaten the integrity or orderly functioning of those markets comprising the wholesale market.
- 3.3.6 The magnitude of the expected efficiency gains cannot be quantified with certainty because dynamic gains arise from actions and improvements that by their nature are difficult to predict.
- 3.3.7 However, an appreciation of the potential magnitudes involved can be gained by considering the overall scale of the industry. The settlement flows in the spot market (wholesale market settlements based on final prices) have averaged around \$2.4 billion per annum over the last five years. If dynamic efficiency gains equivalent to (say) 0.5% of these flows were realised, this would equate to around \$100 million in present value terms.¹⁸
- 3.3.8 The principal *expected* cost of the proposed amendment is the direct cost of consulting on and promulgating the proposed amendment. This is expected to be a relatively minor cost.
- 3.3.9 However, the Authority recognises that there is a different *potential* cost associated with the proposed Code amendment. This is the possibility that the amendment has the unintended effect of raising uncertainty for industry participants. For example, this might occur if participants perceived the amended Code as being less clear than current arrangements.
- 3.3.10 This effect is shown in diagrammatic form in Figure 1. The y-axis shows economic efficiency and the x-axis depicts the nature of the UTS provisions.¹⁹ In this example, the status quo is not optimal in terms of economic efficiency. The proposed Code amendment is intended to shift arrangements to the optimal point, leading to the benefit shown in the diagram. Position 'B' shows the effect if the amendment were to have unintended adverse effects on dynamic efficiency.

¹⁸ This assumes that gains are discounted over 15 years at 8% and realised over a three year phase-in period.

¹⁹ In fact, the UTS provisions can be thought of as having a number of dimensions such as the clarity of the triggers, the range of remedial powers, and the checks and balances on the exercise of those powers. The x-axis treats these as a bundle in this illustrative diagram.

Figure 1: Effect of Code amendment on industry efficiency – illustrative



3.3.11 Although the chart is illustrative in nature, it highlights that the key issue for the cost benefit analysis is the extent to which the proposed amendment increases the effectiveness of the existing UTS provisions.

3.3.12 To form a judgement on this issue, for each major element of the proposed Code amendment, the following sections consider:

- (a) the extent to which the amendment would improve clarity relative to the status quo;
- (b) the extent to which procedural checks and balances on Authority action would be increased or reduced; and
- (c) the extent to which the Authority’s powers would be altered.

3.3.13 The discussion also considers whether the proposed amendment would be consistent with the outcomes that might be expected if contracting parties were bargaining over these provisions in a voluntary multi-lateral setting. In this respect, the UTS provisions in the NZEM represent a useful reference point because they were the outcome of a multilateral negotiation among industry participants at the time.

UTS definition

3.3.14 A number changes are proposed in relation to the UTS definition. The first is to clarify the scope of markets which can give rise to a UTS.

3.3.15 The existing Code limits a UTS to any contingency or event “that threatens, or may threaten, trading on the *wholesale market for electricity*

and that would, or would be likely to, preclude the maintenance of orderly trading or proper settlement of trades” (emphasis added).²⁰ As noted earlier, “wholesale market for electricity” is not defined.

- 3.3.16 The Authority is proposing that the definition of “wholesale market” be clarified as per paragraph 3.1.11. As noted earlier, this definition is consistent with the interpretation of wholesale market commonly used in the industry and adopted by the High Court in its judgment in relation to the UTS on 26 March 2011.²¹ In this respect, the proposed amendment will codify the commonly used definition and remove any scope for uncertainty.
- 3.3.17 Likewise, removing the examples in clause (c) from the definition of a UTS and placing them in Part 5 would not alter the definition of a UTS (as determined by the High Court), but should reduce any scope for uncertainty.
- 3.3.18 Another proposed change is to refocus the definition on the core underlying concern (maintenance of market confidence and integrity) rather than intermediate processes (trading and settlement). This would make it clear that a situation cannot be a UTS unless it can threaten confidence in, or the integrity of, the wholesale market.
- 3.3.19 The Authority considers that this definition better aligns with the policy rationale for UTS provisions, and will reduce the likelihood of UTS provisions being misapplied (either by being triggered inappropriately, or by being inoperative when required).
- 3.3.20 Finally, the proposed definition uses the term “situation” to describe the conditions that could trigger a UTS, rather than “contingency or events”. This term is considered to be more precise and less likely to give rise to uncertainty or unexpected outcomes in the future.

Relevant NZEM provisions on UTS definition as point of comparison

- 3.3.21 The NZEM Rules defined an undesirable situation as “any situation which threatens or may threaten fair, orderly or proper trading on NZEM”. The rule went on to list possible causes of an undesirable situation, but stated that these do not affect the generality of the foregoing provision.
- 3.3.22 The proposed amendment would bring the Code closer to the NZEM definition in some respects, but the Code would be framed around the

²⁰ It also requires that in the reasonable opinion of the Authority, the situation cannot satisfactorily be resolved by any other mechanism available under the Code.

²¹ In that all these definitions include the spot market and hedge market as part of the wholesale market.

underlying concern (maintenance of wholesale market confidence and integrity), rather than trading and settlement processes (as in NZEM Rules). That said, the NZEM definition included examples of situations that could be a UTS, including “any exceptional or unforeseen circumstance, which is at variance with, or which threatens or may threaten, just and equitable principles of trading or the *public interest*” (emphasis added). In this respect, the proposed Code amendment would not be inconsistent with the NZEM Rules.

- 3.3.23 In terms of the scope of markets considered when assessing whether an undesirable situation existed, the NZEM undesirable situation definition referred to trading on “the NZEM”. The NZEM encompassed the spot markets for energy and instantaneous reserves, but did not include the hedge market. That said, the NZEM undesirable situation definition was all encompassing as far as the NZEM itself was concerned.
- 3.3.24 If the same approach were applied for the Code (which covers more aspects of the electricity market), a much broader set of markets (including for example the retail and network services markets) would be assessed. The Authority is not proposing to adopt the broadest definition of any market covered by the Act, but is instead proposing that assessment be confined to the wholesale market where this is defined to be the spot, ancillary services and hedge markets. As noted earlier, this definition is more consistent with the wholesale market definition adopted by the Market Surveillance Committee of the NZEM.²²
- 3.3.25 Furthermore, when considering the alleged undesirable situation in winter of 2001, the Market Surveillance Committee stated that “While the Committee’s jurisdiction is limited to the NZEM the Committee has historically, and in this investigation as well, looked at other markets where that has been relevant in construing or applying the Rules”. More specifically, the Committee looked at the hedge market when assessing whether an undesirable situation existed.
- 3.3.26 Finally, the proposed Code amendment would contain an important limitation on the Authority’s ability to find a UTS that is not contained in the NZEM Rules. Clause (b) requires that, in the reasonable opinion of the Authority, the situation cannot satisfactorily be resolved by any other mechanism available under this Code. No similar express provision existed in the NZEM Rules.

²² At least in so far as the inclusion of the hedge market is concerned.

Overall assessment on UTS definition

- 3.3.27 For the reasons set out above, it is difficult to see any material risk that the definitional changes in the Code amendment would give rise to unintended adverse effects on dynamic efficiency. On the contrary, the greater clarity around the definition of markets covered by the UTS provisions is expected to assist in promoting market confidence.

UTS processes

- 3.3.28 The proposed amendment would preclude an investigation being initiated if the alleged UTS commenced more than ten business days earlier. This provision should increase overall certainty for participants by removing the (albeit remote) potential for UTS provisions to be used to address issues (including reopening final prices) well after an alleged UTS event has occurred.

Relevant NZEM provisions on processes as point of comparison

- 3.3.29 The NZEM Rules did not place any limit on the time period for initiating a UTS investigation.

Overall assessment on UTS processes

- 3.3.30 In light of these factors, it is difficult to see any material potential for the Code amendment to have unintended adverse effects on dynamic efficiency. Indeed, the increased certainty around final prices should enhance confidence and promote dynamic efficiency.

UTS remedies

- 3.3.31 As noted earlier, the Code currently provides that any steps to remedy a UTS must be “in relation to the wholesale market”, but it is not clear whether this means only steps that ‘affect’ the wholesale market, or that are ‘within’ the wholesale market.
- 3.3.32 An amendment is proposed to allow the Authority to take any remedial action, provided it relates to an aspect of the electricity industry that could be regulated in the Code under section 32 of the Act.
- 3.3.33 The other proposed change to UTS remedies is to provide that actions by participants in accordance with an Authority direction would not breach the Code.

- 3.3.34 The proposed amendments are expected to promote certainty by removing the ambiguity that currently exists about how to interpret “in relation to the wholesale market” when directing a UTS remedy.
- 3.3.35 Furthermore, the proposed changes are expected to promote efficiency because they would allow the Authority to choose the UTS remedy that is most consistent with its statutory objective, and subject to the remedy being within the scope of its powers under the Act. In addition, the proposed amendment should facilitate the efficient implementation of UTS remedies because it would reduce the need to make exemptions or take other steps to address concerns that participants might have about liability when acting to implement a UTS remedy.
- 3.3.36 In this context, the Authority also notes that when directing industry participants to undertake actions to correct a UTS, it must not only act in a manner that furthers its statutory objective, it must also follow the principles of administrative law, which at a minimum means that:
- (a) the decision relating to the exercising of the discretion must be reasonable;
 - (b) the Authority must consider all relevant issues; and
 - (c) no irrelevant factors will be allowed improperly to influence the decision.
- 3.3.37 As with any decision by the Authority in regard to a UTS, any party would be able to appeal to the High Court the Authority’s decisions in regard to exercising this jurisdiction to take those steps it considers necessary to correct a UTS.

Relevant NZEM provisions on remedies as point of comparison

- 3.3.38 In relation to the NZEM Rules as a point of comparison for a multi-lateral contract arrangement, the Market Surveillance Committee had very broad powers to correct an undesirable situation.
- 3.3.39 Rule 2.37 provided that the Market Surveillance Committee could “take whatever steps it considers appropriate to correct the situation and may give directions to the Market Administrator or any Market Participant or service provider accordingly, who shall comply with those directions forthwith.”
- 3.3.40 Rule 2.39 provided a non-exhaustive list of steps that the Market Surveillance Committee could take, such as directing a market participant “to transfer any position to one or more of the other Market Participants”.

- 3.3.41 In terms of constraints on the Market Surveillance Committee in addressing an undesirable situation, there was no requirement to adopt remedies consistent with the existing Rules. On the contrary, Rule 2.40 provided that “Any decision of the Market Surveillance Committee ... shall be final, binding and conclusive upon all Market Participants, service providers and the Market Administrator and upon all persons claiming through or under any market Participant.”

Overall assessment on UTS remedies

- 3.3.42 In summary, the proposed amendment to clause 5.2 is expected to make UTS remedies more clear and efficient. The proposed changes would bring the Code closer to the approach taken in the NZEM Rules. For these reasons, the proposed amendment is expected to enhance certainty and promote dynamic efficiency.

Protections available to participants under statute

- 3.3.43 The preceding sections concluded that it is unlikely that the proposed Code amendment would alter arrangements in a way that causes unintended dynamic efficiency losses (i.e. ‘overshooting’ in terms of Figure 1). This is based on an analysis of the expected effect of each element of the proposed amendment.
- 3.3.44 However, it is important to note that there are other safeguards that act as a check on the Authority’s powers. In particular, the Authority must act in a manner that furthers its statutory objective, and its actions are subject to appeal and review in the Courts.
- 3.3.45 In some respects, this is a more powerful check on the exercise of power than would be available under a multi-lateral contract. In the latter case, the principal check on perceived mis-use of power is for a participant to withdraw from the contract and seek to conduct its business under a different arrangement. However, this pre-supposes the existence of such an alternative, and/or the ability to establish a viable competing arrangement from scratch. In both cases there are likely to be material costs and or business risks to effect a transition, especially if the party is acting by itself (i.e. the concern is not widely shared by a majority of industry participants). By contrast, while the costs involved in a legal challenge are not trivial, they are likely to be within the means of most if not all industry participants.
- 3.3.46 The existence of this important safeguard provides further assurance that the proposed Code amendment is likely to facilitate efficiency-enhancing

actions by the Authority, and that unintended adverse effects are unlikely to arise.

3.4 Evaluation of alternative means of achieving the objectives of the proposed amendment

3.4.1 As noted above, the objectives of the proposed amendment are to:

- (a) remove ambiguity from the definition of a UTS;
- (b) reduce uncertainty in relation to the finality of published settlement prices; and
- (c) improve the efficiency of the remedies available to the Authority when a UTS has occurred.

3.4.2 The Authority is not aware of any alternative mechanism(s) to address the identified shortcomings of the existing UTS provisions.

3.5 Assessment under section 32(1)

3.5.1 Section 32(1) of the Act provides that Code provisions must be consistent with the Authority's objective and be necessary or desirable to promote any or all of the following:

- (a) competition in the electricity industry
- (b) the reliable supply of electricity to consumers
- (c) the efficient operation of the electricity industry
- (d) the performance by the Authority of its functions
- (e) any other matters specifically referred to in this Act as a matter for inclusion in the Code.

3.5.2 The table below sets out an assessment of the proposed amendment against the requirements of section 32(1) of the Act.

Section 32(1) requirements:	Response
<p>The proposed amendment is consistent with the Authority's objective under section 15 of the Act, which is as follows:</p>	
<p>(a) to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers</p>	<p>The proposed amendment is designed to improve the efficiency of the UTS provisions in the Code, which will also assist the Authority to better achieve its statutory objective.</p> <p>As noted in section 2 of this consultation paper, the UTS Code provisions are consistent with facilitating and encouraging competition (limb 1 of the Authority's statutory objective) and increasing the efficiency of the electricity industry (limb 3).</p> <p>Hence, by improving the efficiency of the UTS provisions in the Code, the proposed amendment is consistent with the Authority's objective under section 15 of the Act.</p>
<p>The proposed amendment is necessary or desirable to promote any or all of the following:</p>	
<p>(b) competition in the electricity industry;</p>	<p>Refer above.</p>
<p>(c) the reliable supply of electricity to consumers;</p>	
<p>(d) the efficient operation of the electricity industry;</p>	<p>Refer above.</p>
<p>(e) the performance by the Authority of its functions;</p>	<p>Refer above.</p>
<p>(f) any other matter specifically referred to in this Act as a matter for inclusion in the Code.</p>	

3.6 Assessment against the code amendment principles

3.6.1 When considering amendments to the Code, the Authority is required by its Consultation Charter to have regard to the following Code amendment principles, to the extent that the Authority considers that they are applicable.

3.6.2 *Principle 1 – Lawfulness:* The Authority and its advisory groups will only consider amendments to the Code that are lawful and that are consistent with the Act (and therefore consistent with the Authority’s statutory objective and its obligations under the Act).

3.6.3 [The proposed amendment has been legally reviewed and is consistent with the Act.]

3.6.4 *Principle 2 – Clearly Identified Efficiency Gain or Market or Regulatory Failure:* Within the legal framework specified in Principle 1, the Authority and its advisory groups will only consider using the Code to regulate market activity when:

- (a) it can be demonstrated that amendments to the Code will improve the efficiency of the electricity²³ industry for the long-term benefit of consumers;
- (b) market failure is clearly identified, such as may arise from market power, externalities, asymmetric information and prohibitive transaction costs; or
- (c) a problem is created by the existing Code, which either requires an amendment to the Code, or an amendment to the way in which the Code is applied.

3.6.5 [The regulatory failure in this instance is that the current UTS provisions lack clarity in some respects (creating areas of uncertainty for participants), or encourage the Authority to take actions that are less efficient than would be preferred (e.g. using exemption provisions to ensure that actions to implement a UTS direction do not breach the Code). The proposed Code amendment is designed to address these issues.]

3.6.6 *Principle 3 – Quantitative Assessment:* When considering possible amendments to the Code, the Authority and its advisory groups will ensure disclosure of key assumptions and sensitivities, and use quantitative cost-

²³ Where efficiency refers to allocative, productive and dynamic efficiency, and improvements to efficiency include, for example, a reduction in transaction costs or a reduction in the scope for disputes between industry participants.

benefit analysis to assess long-term net benefits for consumers, although the Authority recognises that quantitative analysis will not always be possible. This approach means that competition and reliability are assessed solely in regard to their economic efficiency effects. Particular care will be taken to include dynamic efficiency effects in the assessment, and the assessment will include sensitivity analysis when there is uncertainty about key parameters.

- 3.6.7 The UTS provisions are designed to address situations which cannot reasonably be dealt with by existing provisions under the Code. These situations are by nature difficult to foresee and predict.
- 3.6.8 Accordingly, it is not possible to undertake detailed quantitative analysis on the expected effects of the proposed Code amendment. However, a qualitative analysis is set out earlier in this paper.
- 3.6.9 *Principle 4 – Preference for Small-Scale ‘Trial and Error’ Options:* When considering possible amendments to the Code, the Authority and its advisory groups will give preference to options that are initially small-scale, and flexible, scalable and relatively easily reversible with relatively low value transfers associated with doing so. In these circumstances the Authority will monitor the effects of the implemented option and reject, refine or expand that solution in accordance with the results from the monitoring.
- 3.6.10 The proposed changes are consistent with this principle. They are refinements to the existing Code provisions where specific issues have been identified. It would be possible to adopt a more fundamental review of the UTS provisions which would not be small-scale, but that is not the approach being proposed by the Authority.
- 3.6.11 *Principle 5 – Preference for Greater Competition:* The Authority and its advisory groups will give preference to Code amendment options that have larger pro-competition effects, because greater competition is *likely* to be positive for economic efficiency and reliability of supply.
- 3.6.12 The proposed Code amendment is expected to be pro-competitive by reducing the scope for situations to arise that threaten, or may threaten, confidence in, or the integrity of, the wholesale market.
- 3.6.13 *Principle 6 – Preference for Market Solutions:* The Authority and its advisory groups will give preference to Code amendment options that directly address the source of the market failure identified under Principle 2, so as to facilitate efficient market arrangements. The Authority and its advisory groups will discount options that subdue or displace efficient market structures.

- 3.6.14 As noted above, the issue in this instance is a regulatory failure in that the existing UTS provisions are judged to be sub-optimal. The proposed Code amendment is intended to support market solutions by reducing the scope for situations to arise that threaten, or may threaten, confidence in, or the integrity of, the wholesale market.
- 3.6.15 *Principle 7 – Preference for flexibility to allow innovation:* The Authority and its advisory groups will give preference to Code amendment options that provide industry participants with greater freedom and lower costs to adapt to the Code amendment as they see fit, unless more restrictive options are justified on the grounds of non-rivalry and/or non-excludability conditions.²⁴ In the case where both conditions hold perfectly it is generally efficient to adopt a ‘one size fits all’ approach, such as uniform standards. Where these conditions do not hold it may be more efficient to utilise flexible mechanisms, such as incentives.
- 3.6.16 The proposed Code amendments are generic by their nature and allow participants to decide how to adapt to the proposed amendment.
- 3.6.17 *Principle 8 – Preference for Non-Prescriptive Options:* Wherever practicable, when the Authority and its advisory groups are considering standards, they will give preference to Code amendment options that specify the outcomes required of industry participants rather than prescribe what they must do and how they must do it. That is, outcome standards are preferred to input standards, wherever possible.
- 3.6.18 The proposed Code amendments are outcome-based. For example, the proposed definitional changes are oriented toward protecting the confidence in, and the integrity of, the wholesale market. The proposed Code amendments do not prescribe the scope of actions to be taken by individual participants, other than the Authority.
- 3.6.19 *Principle 9 – Risk Reporting:* The Authority will publish a report:
- (a) That assesses the risks of making and not making the Code amendment, taking into account Principles 5 – 8, and factoring in the option value associated with waiting longer before intervening.

²⁴ A good or service is *non-rival* when additional consumption by one party does not reduce the amount available for any other party to consume. For example, electricity consumption is rival but security of supply is non-rival. A good or service is *non-excludable* when it is not economically viable to exclude parties from consuming the good or service. For example, electricity consumption is excludable because retailers generally incur a relatively low economic cost to cut power supply to consumers that do not pay their electricity bills. On the other hand, market prices are non-excludable because it is too costly to prevent disclosure of prices to parties that do not contribute to the costs of operating the market.

- (b) That identifies and assesses non-Code methods for mitigating or addressing the problem.

3.6.20 Given the issues identified in light of recent experience, the Authority considers it desirable for the Code to be amended to remedy these issues. |

3.7 Summary of questions

- Q1.** Do you agree with the proposal that the current definition of “wholesale market” should be clarified as including the spot market for electricity, the ancillary services markets and the hedge market, and that clause 9.14(2)(a) of the Code should be amended accordingly?
- If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority’s statutory objective in section 15 of the Act.
- Q2.** Do you agree with the proposed changes to Part 1 of the Code to clarify the definition of a UTS?
- If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority’s statutory objective in section 15 of the Act.
- Q3.** Do you agree that the examples in paragraph (c) of the current definition of a UTS should be retained in the Code, and moved to Part 5?
- If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority’s statutory objective in section 15 of the Act.
- Q4.** Do you agree with the proposed changes to clause 13.255 of the Code to align it with the suggested changes to UTS provisions?
- If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority’s statutory objective in section 15 of the Act.
- Q5.** Do you agree with the proposal that there should be a restriction on the Authority initiating a UTS investigation for situations earlier than a defined time limit in the past?
- If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority’s statutory objective in section 15 of the Act.
- Q6.** Do you agree with the proposal that the time limit should be no more than 10 business days, and apply between the commencement of the

alleged UTS and the date the Authority initiates an investigation?

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority's statutory objective in section 15 of the Act.

Q7. Do you agree with the proposal that there should be no time limit on republication of final prices per se?

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority's statutory objective in section 15 of the Act.

Q8. Do you agree with the proposal that the Authority should be able to take any action to remedy a UTS, provided the action relates to an aspect of the electricity industry that the Authority could regulate in the Code under section 32 of the Act?

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority's statutory objective in section 15 of the Act.

Q9. Do you agree with the proposal that industry participants following directions from the Authority do not face the risk of breaching the Code as a consequence of doing so?

If you agree/disagree, please explain why, including why in your view the proposal is consistent/inconsistent with achieving the Authority's statutory objective in section 15 of the Act.

References

Electricity Authority, *Final decision on the Undesirable Trading Situation of 26 March 2011*, 4 July 2011

NZEM Market Surveillance Committee, *Claimed Undesirable Situation arising from high spot prices in May / June 2001*, memorandum, 17 July 2001

New Zealand Electricity Market, *Rules of NZEM*, 2003

NZ High Court, *Bay of Plenty Energy Limited v Electricity Authority [2012] NZHC 238*, 2012

Appendix 1 Format for submissions

Question No.	General comments in regards to the:	Response

Appendix 2 Proposed amendment

Electricity Industry Participation Code 2010

Part 1 Preliminary provisions

undesirable trading situation means any ~~situation~~ contingency or event—

- (a) that threatens, or may threaten, confidence in, or the integrity of, trading on the wholesale market for electricity and that would, or would be likely to, preclude the maintenance of orderly trading or proper settlement of trades; and
- (b) that, in the reasonable opinion of the **Authority**, cannot satisfactorily be resolved by any other mechanism available under this Code; and
- (c) ~~includes, without limitation,—~~
 - (i) ~~manipulative or attempted manipulative trading activity; and~~
 - (ii) ~~conduct in relation to trading that is misleading or deceptive, or likely to mislead or deceive; and~~
 - (iii) ~~unwarranted speculation or an undesirable practice; and~~
 - (iv) ~~material breach of any law; and~~
 - (v) ~~any exceptional or unforeseen circumstance that is at variance with, or that threatens or may threaten, generally accepted principles of trading or the public interest~~

wholesale market means ~~the wholesale market for electricity—~~

- (a) the spot market for electricity, including the process for setting—
 - (i) real time prices:
 - (ii) forecast prices and forecast reserve prices:
 - (iii) provisional prices and provisional reserve prices:
 - (iv) interim prices and interim reserve prices:
 - (v) final prices and final reserve prices:

(b) markets for **ancillary services**:

(c) the hedge market for **electricity**, including the market for **FTRs**

Part 5

Regime for dealing with undesirable trading situations

Contents

- 5.1 Occurrence of undesirable trading situation
 - 5.1A Time limit for investigating undesirable trading situation
 - 5.2 Actions Authority may take to correct undesirable trading situation
 - 5.3 Authority must consult with system operator
 - 5.4 Authority must consult with participants
 - 5.5 Authority must attempt to correct and restore normal operation as soon as possible
-

5.1 Occurrence of undesirable trading situation

- (1) If the **Authority** suspects or anticipates the development, or possible development, of an **undesirable trading situation**, the **Authority** may investigate the matter.
- (2) The following are examples of what the **Authority** may consider to constitute an **undesirable trading situation**:
 - (a) manipulative or attempted manipulative trading activity:
 - (b) conduct in relation to trading that is misleading or deceptive, or is likely to mislead or deceive:
 - (c) unwarranted speculation or an undesirable practice:
 - (d) material breach of any law:
 - (e) a situation that threatens orderly trading or proper settlement:
 - (f) any exceptional or unforeseen circumstance that is contrary to the public interest.
- (3) To avoid doubt—
 - (a) the list of examples in subclause (2) is not an exhaustive list, and does not prevent the **Authority** from finding that an **undesirable trading situation** is developing or has developed in other circumstances; and
 - (b) an example listed in subclause (2) does not constitute an **undesirable trading situation** unless the example comes within the definition of that term in Part 1.

Compare: SR 2003/374 r 54

5.1A Time limit for investigating undesirable trading situation

Despite clause 5.1(1), the **Authority** must not commence an investigation if 10 **business days** or more have passed since the situation, which the **Authority** suspects or anticipates may be an **undesirable trading situation**, occurred.

5.2 Actions Authority may take to correct undesirable trading situation

- (1) If the **Authority** finds that an **undesirable trading situation** is developing or has developed, it may take any ~~of the action steps listed in subclause (2) in relation to the wholesale market~~ that—
 - (a) the **Authority** considers is ~~are~~ necessary to correct the **undesirable trading situation**; and
 - (b) relates to an aspect of the **electricity** industry that the **Authority** could regulate in this Code under section 32 of the **Act**.
- (2) The actions steps that the **Authority** may take under subclause (1) include any 1 or more of the following:
 - (a) directing that ~~suspending, or limiting or curtailing,~~ an activity ~~on the wholesale market~~, be suspended, limited or stopped, either generally or for a specified period;
 - (b) directing that ~~deferring~~ completion of trades be deferred for a specified period;
 - (c) directing that any trades be closed out or settled at a specified price;
 - (d) giving directions to ~~directing a participant to take any actions~~ **act in a manner** (not inconsistent with this Code, the **Act**, or any other law) that will, in the **Authority's** opinion, correct or assist in overcoming the **undesirable trading situation**.
- (2A) A direction given to a **participant** under subclause (2)(d)—
 - (a) may be inconsistent with this Code; but
 - (b) must not be inconsistent with the **Act**, or any other law.
- (3) The **participant** must comply promptly with a direction given to it in writing.
- (4) ~~Neither a **participant** nor the **Authority**~~ is not liable to any other **participant** in relation to the taking of an action, or an omission, that is reasonably necessary for compliance with an **Authority** direction under this clause.
- (5) A **participant** does not breach this Code if it acts in accordance with a direction given under subclause (2)(d).
Compare: SR 2003/374 r 56

5.3 Authority must consult with system operator

- (1) The **Authority** must consult with the **system operator** if—
 - (a) the **Authority** is considering taking an action under clause 5.2 to correct an **undesirable trading situation**; and
 - (b) it is possible that the action may have an effect on **system security**.
- (2) The **system operator** must maintain procedures that are necessary to enable it to respond immediately to the **Authority**, and provide information as soon as reasonably practicable, if the **Authority** consults the **system operator** under this clause.
Compare: SR 2003/374 r 58

5.4 Authority must consult with participants

If the **Authority** finds that an **undesirable trading situation** is developing or has developed, the **Authority** must—

- (a) immediately advise all **registered participants** of its findings and of any actions that the **Authority** intends to take, or has taken, to correct the **undesirable trading situation**; and
- (b) unless the **Authority** considers that it is impractical to do so, consult with affected **participants** before taking the action.

Compare: SR 2003/374 r 59

5.5 Authority must attempt to correct and restore normal operation as soon as possible

The **Authority** must attempt to correct every **undesirable trading situation** and, consistently with section 15 of the **Act**, restore the normal operation of the **wholesale market** as soon as possible.

Compare: SR 2003/374 r 60

Part 13 Trading arrangements

13.255 Authority may direct FTR manager to suspend allocation of FTRs

The **Authority** may direct the **FTR manager** to suspend the allocation of **FTRs** if there is any situation ~~contingency or event~~ that—

- (a) threatens, or may threaten, confidence in, or the integrity of, the allocation or settlement of **FTRs** ~~and that would, or would be likely to, preclude the maintenance of orderly allocation or trading of FTRs or proper settlement of FTRs~~; and
- (b) ~~that,~~ in the reasonable opinion of the **Authority**, cannot satisfactorily be resolved by any other mechanism available under this Code.

Appendix 3 Part 5 of the Code – Existing

Electricity Industry Participation Code 2010

Part 5

Regime for dealing with undesirable trading situations

Contents

- 5.1 Occurrence of undesirable trading situation
- 5.2 Actions Authority may take to correct undesirable trading situation
- 5.3 Authority must consult with system operator
- 5.4 Authority must consult with participants
- 5.5 Authority must attempt to correct and restore normal operation as soon as possible

5.1 Occurrence of undesirable trading situation

If the **Authority** suspects or anticipates the development, or possible development, of an **undesirable trading situation**, the **Authority** may investigate the matter.

Compare: SR 2003/374 r 54

5.2 Actions Authority may take to correct undesirable trading situation

- (1) If the **Authority** finds that an **undesirable trading situation** is developing or has developed, it may take any of the steps listed in subclause (2) in relation to the **wholesale market** that the **Authority** considers are necessary to correct the **undesirable trading situation**.
- (2) The steps that the **Authority** may take include any 1 or more of the following:
 - (a) suspending, or limiting or curtailing, an activity on the **wholesale market**, either generally or for a specified period;
 - (b) deferring completion of trades for a specified period;
 - (c) directing that any trades be closed out or settled at a specified price;
 - (d) giving directions to a **participant** to act in a manner (not inconsistent with this Code, the **Act**, or any other law) that will, in the **Authority's** opinion, correct or assist in overcoming the **undesirable trading situation**.
- (3) The **participant** must comply promptly with a direction given to it in writing.
- (4) Neither a **participant** nor the **Authority** is liable to any other **participant** in relation to the taking of an action, or an omission, that is reasonably necessary for compliance with an **Authority** direction under this clause.

Compare: SR 2003/374 r 56

5.3 Authority must consult with system operator

- (1) The **Authority** must consult with the **system operator** if—
 - (a) the **Authority** is considering taking an action under clause 5.2 to correct an **undesirable trading situation**; and
 - (b) it is possible that the action may have an effect on **system security**.

- (2) The **system operator** must maintain procedures that are necessary to enable it to respond immediately to the **Authority**, and provide information as soon as reasonably practicable, if the **Authority** consults the **system operator** under this clause.

Compare: SR 2003/374 r 58

5.4 **Authority must consult with participants**

If the **Authority** finds that an **undesirable trading situation** is developing or has developed, the **Authority** must—

- (a) immediately advise all **registered participants** of its findings and of any actions that the **Authority** intends to take, or has taken, to correct the **undesirable trading situation**; and
- (b) unless the **Authority** considers that it is impractical to do so, consult with affected **participants** before taking the action.

Compare: SR 2003/374 r 59

5.5 **Authority must attempt to correct and restore normal operation as soon as possible**

The **Authority** must attempt to correct every **undesirable trading situation** and, consistently with section 15 of the **Act**, restore the normal operation of the **wholesale market** as soon as possible.

Compare: SR 2003/374 r 60