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**TRUSTPOWER SUBMISSION: REVIEW OF THE UNDESIRABLE TRADING SITUATION (UTS) PROVISIONS**

Thank you for the opportunity to provide a submission on the consultation relating the review of the UTS provisions in the Code.

We support some of the amendments to the UTS provisions proposed by the Electricity Authority (“Authority”), but not all.

We note that the amendments proposed are aimed at improving the clarity of the definition of the UTS provisions and providing more certainty on the timeframes which apply to the initiation of a UTS investigation. A recent trigger for the review is the decision of the High Court in *Bay of Plenty Energy Ltd v Electricity Authority* [2012] NZHC 238 (**BOPE appeal**). The High Court’s decision considered, and upheld, the decision of the Electricity Authority to find a UTS existed in relation to the much publicised market events of 26 March 2011.

A number of parties to the BOPE appeal argued for different interpretations of the UTS provisions in the Code. Against that context, we can understand why the Authority decided the UTS review was necessary.

A key point in the case was whether a wide or narrow interpretation should be taken of the events which constitute a UTS. A narrow interpretation would focus on whether any inputs to orderly trading had been adversely affected; a wider interpretation would involve taking into account the effect on trading outcomes more generally.

The High Court unequivocally found in favour of the wider meaning. In the course of its examination of the relevant sections of the Code, the Court noted the confusion which had arisen as a result of the inclusion of the illustrative clause (c) (v), which refers to conduct that threatens “*acceptable principles of trading*”, and the mandatory clause (a), which refers to conduct “*likely to preclude orderly trading*”.

We support changes to clarify this confusion. We also support, with minor modifications, the Authority’s proposal to introduce a time limit for the triggering of a UTS investigation.

However the proposals in the Authority’s Consultation Paper go beyond what is necessary to address the ambiguity highlighted in the BOPE appeal, and instead involve a significant change of policy. In particular, the Authority is proposing to extend its UTS jurisdiction to include the hedge markets and the ancillary services markets, and to widen the range of remedies it may direct market participants to take to correct a UTS.

This will mean the industry will lose the benefit of the past decisions by the Market Surveillance Committee, Electricity Commission, Electricity Authority and High Court on what constitutes a UTS.

The Authority has not adequately explained the reasons for the proposed expansion of its UTS jurisdiction, nor examined alternative options to the proposed amendments (which could include, for example, regulated terms for ancillary service or hedge contracts). This raises questions about whether the Authority has properly complied with its code amendment obligations.

We are concerned that there may be other parties involved in a UTS that are not subject to the Authority's jurisdiction. This could include, for example, contract counterparties who are not covered by the Code or even other market institutions such as the ASX. The Consultation Paper does not explain how this issue would be managed across the sector.

In summary, we are concerned that instead of clarifying the UTS provisions, some of the proposed changes will adversely impact regulatory certainty. This means the changes would be unlikely to pass the required cost benefit analysis compared with either the status quo or a more limited set of Code changes, as outlined in our accompanying submission.

Please feel free to contact me if you have any questions regarding this submission.

Yours faithfully,

A handwritten signature in blue ink, appearing to read 'Therese Thorn', is positioned above the typed name.

**THERESE THORN**  
**GENERAL MANAGER TRADING**

## Submission by TrustPower Limited

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| <p>1. 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.</p> | <p>1.1 No. TrustPower believes that the Authority’s proposal is not merely a “clarification” – it is in fact a significant policy change. The Consultation Paper is proposing to allow the Authority to intervene and override existing (and future) contracted risk management arrangements in the ancillary services and hedge markets.</p> <p>1.2 The Consultation Paper does not contain any analysis of why this is necessary. Without further information about the problem(s) the Authority is trying to address in these markets, it is not possible to have confidence that the Authority has identified all practical solutions to any problems in these markets.</p> <p>1.3 In terms of the current Code, TrustPower considers that the term “wholesale market” is actually synonymous with the term “spot market”. Evidence for this view is:</p> <ul style="list-style-type: none"> <li>a) the drafting history of the UTS provisions (especially the fact that the rule previously referred to the NZEM);</li> <li>b) the structure of the UTS sections, for example the nature of the activity described in the first limb: “trading <b>on</b> the market”, “orderly trading”, “proper settlement <b>of</b> trading”; and</li> <li>c) the remedies available to the Authority on breach of the clause e.g. “suspending activity on the market”, “deferring completion of trades”, “directing that trades be closed out”, etc.</li> </ul> <p>1.4 It follows that the Consultation paper’s proposal is therefore a policy change. The question then arises whether the Authority should have UTS powers in relation to the ancillary services market and the hedge market contracts. These are discussed separately below.</p> <p style="text-align: center;"><b>Extension to ancillary services markets</b></p> <p>1.5 The rationale given by the Authority for including ancillary services markets within the wholesale market definition in the UTS provisions is that “<i>these services are fundamental to the orderly operation of the wholesale market for electrical energy</i>” (see para 3.1.5 of the Consultation Paper). With respect, this appears to confuse two concepts: the possibility that an event in the ancillary services market could create an undesirable situation in the spot market and the possibility that the contracts within the markets for ancillary services do not adequately address unforeseen circumstances.</p> <p>1.6 In relation to the first point, TrustPower considers that this possibility <b>should</b> be covered in the definition of a UTS, but that it currently <b>is</b> covered by the existing definition. Such an event would be covered by the first limb – “<i>may threaten trading</i>” – and also be consistent with the example in (c) (v) – “<i>exceptional or unforeseen circumstance that is at variance with ... the public interest</i>”.</p> <p>1.7 It is also consistent with the High Court’s interpretation of the UTS provision in Bay of Plenty Energy Ltd versus Electricity Authority [2012] NZHC 238 (<b>BOPE appeal</b>), where the court accepted that when looking at whether a particular event or set of events affected orderly trading on the spot market, the provisions should be interpreted broadly, taking into account the Authority’s statutory objective and functions:</p> |
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*"[97] The Authority approached the meaning of the word "orderly" as something more than the completion of trades as anticipated by the Code. In my view this was correct. "Orderly" in this context is concerned with the completion of trades as anticipated by the Code in a technical sense but is also concerned with a wider meaning of orderly, for example that all market participants would be trading on a level playing field..."*

*[100] The idea of an orderly market can, as the Authority also recognised, be assessed against the Authority's statutory objectives. If the Authority's job, in part, is to ensure the functioning of the electricity market by promoting its statutory objective, then an assessment of the orderly trading element will inevitably involve an assessment of how the particular events under scrutiny affect these statutory criteria.*

*[101] And so, the preclusion of orderly trading does not require that trading is or is likely to halt. Trading may continue but orderly trading, that is orderly trading in the sense described by the Authority, will not continue. An event would have occurred which has affected the market that if it is allowed to continue means that trading will not be on a level playing field."*

1.8 TrustPower considers that in the light of this guidance from the High Court, the Authority can be confident that if a significant event occurred in the ancillary services market and affected the spot market, the Authority would have jurisdiction to investigate and take appropriate action.

1.9 This leaves the second point, namely whether it is appropriate for the Authority to intervene and overrule the terms and conditions of existing ancillary services contracts on the basis of public interest or an *ex post* assessment of the adequacy of bilaterally-negotiated risk management arrangements. The paper does not explain why this is needed. Nor does it outline other options which could address this issue, such as regulated contract terms. In general, TrustPower would favour *ex ante* regulated terms over an *ex post* regulatory intervention. However the case for neither has been made.

#### **Extension to hedge markets**

1.10 The Authority is also proposing to extend its UTS jurisdiction to include hedge markets. This is also said to be a "*clarification*" which is "*consistent with the interpretation commonly used in the industry and suggested by the High Court in the Bay of Plenty Electricity case*" (see the Executive Summary of the Consultation Paper). Once again, a distinction needs to be made between the events which affect the spot market and unforeseen events in the various hedge markets.

1.11 TrustPower would agree with the Authority that events in the hedge markets which affect the spot market should be able to be taken into account in considering whether a UTS has formed in the spot market, but does not agree that any changes need to be made to the definition for this to occur.

1.12 This is already the case under the current law. For example, in the May/June 2001 MSC case quoted in the Consultation Paper, the Committee observed:

*"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. In this case the Committee has considered not only the spot market administered by NZEM but also, to the extent of information available to it, the hedge market and the retail market.”*

1.13 TrustPower does not consider the BOPE appeal decision is authority for an interpretation of the definition of wholesale market as inclusive of the hedge market. This case was solely concerned with the spot market and did not consider other markets such as ASX traded hedge markets.

1.14 When considering whether the hedge markets should be included in the UTS provisions of the Code, the first question to consider is the definition of a *“hedge market for electricity”*. Failure to define the term is a significant weakness of the Consultation Paper. In the MSC decision quoted above, the term hedge is defined as follows:

*“Hedge’ is used to describe an arrangements or statement of affairs which manages, or can be used to manage, a Market Participant’s exposure to the spot price.*

*Examples considered by the Committee were:*

*a) the financial hedge under which Market Participants agree to make payments to one another by reference to the spot price and to particular quantities of electricity notionally supplied at particular times and at, or by reference to , particular supply points – no physical delivery under the hedge being contemplated;*

*b) the physical hedge under which a Market Participant agrees to make physical supply to its own customers, large and small, be they industrial, commercial or residential. Supply terms, including (critically) the right to interrupt supply, and the right to change the price and volume of supply, will vary as between these customers.”*

1.15 The jurisdiction that the Authority has over the hedge market defined this broadly is extremely problematic. While the Act requires the Authority to facilitate an active hedge market, this in itself does not give the Authority the ability to regulate over all financial instruments which may settle against the electricity spot market. Nor does it suggest that the Authority should claim over-arching governance over all the other arrangements market participants enter to manage their exposure to spot prices.

1.16 Before expanding its jurisdiction in this way the Authority needs to be more specific about the shortcomings of the current hedge market arrangements:

- a) Does the Authority consider the ASX contracts are inadequate?
- b) How does the Authority see its jurisdiction over hedge contracts fitting with the jurisdiction of other organised markets such as the ASX?
- c) Has the Authority evidence that bilateral hedge contracts are inefficient? If so, which ones?
- d) Does the Authority consider physical and financial hedges are in the same or separate markets?

1.17 The Authority is clearly cognisant of the limit to the remedies it has in relation to its proposed expansion of its

	<p>UTS jurisdiction. Thus in its Consultation Paper it restricts its remedial actions to actions it would have had available to it under the Code. However, the paper does not explain how its proposed remedies would work in practice if a hedge counterparty were outside the Code’s jurisdiction.</p> <p>1.18 A long-term consequence of the Authority’s proposal might be to limit those who trade in energy to market participants, which would limit the ability of intermediaries to assist in trading the forward curve. This would clearly not be in the long-term interests of consumers.</p> <p>1.19 In summary, in determining whether or not it should change the existing definition of “wholesale market”, the Authority must:</p> <ul style="list-style-type: none"> <li>a) explain why it is necessary to provide a remedy for unforeseen events in the hedge and ancillary services markets over and above the arrangements parties have already negotiated or can negotiate in future to cover these circumstances;</li> <li>b) note that the extension of the UTS could create considerable uncertainty for existing and future bilateral contracts;</li> <li>c) note that the current reference to “the hedge market for electricity” could include both physical and financial arrangements and yet the Authority has no ability to order a remedy from a contract counterparty who is not bound by the Code; and</li> <li>d) consider the inefficiencies and risks arising for market participants who trade hedge products in other markets.</li> </ul>
<p>2. 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.</p>	<p>2.1 TrustPower agrees with <u>some</u> of the proposed changes to part 1 of the Code, <u>but not all</u>. It agrees with those changes which are necessary to clarify the meaning of the UTS provisions in accordance with the High Court decision in the BOPE appeal, but not with the changes which extend the scope of the UTS provisions.</p> <p>2.2 In particular it agrees:</p> <ul style="list-style-type: none"> <li>a) with the removal of the examples in sub clause (c) of the current definition to a separate section of the Code to make it clear that (a) and (b) of the UTS definition are mandatory and the examples are only illustrative. This is consistent with the BOPE appeal decision; and</li> <li>b) with the deletion of the phrase “<i>that threatens or may threaten generally accepted principles of trading</i>” from the list of illustrative examples in sub clause (c), as it is a lower standard than the mandatory part of sub clause (a) of the current definition namely, “<i>that would, or would be likely to, preclude the maintenance of orderly trading or proper settlement of trades</i>” and is therefore redundant. TrustPower notes this change is all that is required to address the High Court’s concern about the “<i>difficulties</i>” with the definition of a UTS.</li> </ul> <p>2.3 TrustPower does not agree that it is necessary:</p> <ul style="list-style-type: none"> <li>a) to remove the references to “<i>trading and settlement</i>” in the core definition and replace them with references to the maintenance of “<i>confidence and integrity</i>”; or</li> </ul>

	<p>b) to change the phrase “<i>event or circumstance</i>” to “<i>situation</i>”.</p> <p>2.4 Over the years, TrustPower has claimed (and been successful in claiming) Undesirable Trading Situations (UTSs). The proposed changes to Part 1 of the Code will remove the clarity about what may constitute a UTS.</p> <p>2.5 TrustPower notes a UTS may relate to a circumstance which has already occurred but for some reason cannot reoccur. The aggrieved party, however, needs to have the UTS agreed to enable restitution. This is a core part of the current arrangements which may not be covered if there is a change in language used.</p> <p>2.6 TrustPower does not consider the case has been made to change the words “<i>event or circumstance</i>” to “<i>situation</i>”. The High Court was very specific that “<i>both words can include a combination of factors and typically will do so</i>” (para 119). Therefore there is no justification for a change.</p> <p>2.7 The main point is that the industry currently has the benefit of 17 past decisions on UTSs, and a detailed High Court case. This provides the market with a high level of regulatory clarity. As noted above, the High Court supported a wider meaning of “<i>orderly trading</i>” and recognised that the phrase needed to be interpreted against the Authority’s statutory objective. If the definition is changed in accordance with the Authority’s “<i>preferences</i>” the industry will lose the benefit of past precedents and judicial interpretation.</p> <p>2.8 Further, in any future examination of these provisions a court is likely to interpret the changes as meaning something much wider than the current Code (as interpreted by the High Court). There is also a risk that a court would find it harder to review a wider and more subjective test, and instead defer to the Authority’s expertise as an expert body resulting in a diminution of the current protections available to industry participants under statute.</p> <p>2.9 Thus the proposed changes are a recipe for significant regulatory uncertainty, not regulatory clarity.</p>
<p>3. 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.</p>	<p>3.1 See comments above in the answer to Q2.</p>
<p>4. 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.</p>	<p>4.1 No, TrustPower disagrees. Clause 13.255 should be retained as it is currently.</p> <p>4.2 This is consistent with TrustPower’s position on the UTS definition outlined in the answers to Q1 and Q2 above.</p>
<p>5. Do you agree with the proposal that there should be a</p>	<p>5.1 Yes. Finality is important for participant confidence in the stability of the market.</p>

<p>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.</p>	
<p>6. 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.</p>	<p>6.1 TrustPower agrees that the time period for alleging a UTS should be limited. However, while the proposal states that the ten-day time limit would apply to “<i>the date the Authority initiates an investigation</i>”, it may be more appropriate for the ten-day time limit to apply to the period between the end of the alleged UTS and the time at which a participant or the Authority makes an allegation of a UTS.</p> <p>6.2 TrustPower would much prefer the time limit to be associated with the settlement dates following a UTS. Under current market processes, settlement date is the 20<sup>th</sup> of the month following, and some participants may not be aware they have been disadvantaged by an undesirable event or circumstance until they receive their invoice. This could be much later than ten business days after the event. It may therefore be appropriate to extend the time period in question so that it ends “five days after receipt of the first invoice using the affected final prices” (or words to that effect). The final date for alleging a UTS would then be five or so business days before the 20<sup>th</sup> of the month (or the first date on which settlement has occurred in relation to those final prices).</p> <p>6.3 In that event, if a UTS is alleged, the Authority must notify the market within one day of receipt of the UTS allegation of the prices that may be subject to change, so that each participant can ensure that their own settlements (including hedges, etc.) reflect the uncertainty of the final prices.</p> <p>6.4 In a way, it could be argued that those prices subject to a UTS claim are now no longer final, instead becoming <i>contested final prices</i>.</p>
<p>7. 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.</p>	<p>7.1 TrustPower disagrees that there should not be a time limit on republication of final prices <i>per se</i>. Prices that are uncontested need to be final when payment for the first invoice using them is made. The only prices that could be changed would be <i>contested final prices</i>, as discussed in the answer to Q6 above. For these contested final prices, however, the time to determine or confirm them can be a reasonable period. This recommendation applies to prices subject to a pricing error as well as to a UTS.</p> <p>7.2 The Authority should be mindful of the history of final price-setting when making its decision. Until the Penrose/Mt Roskill metering event of 1998-2000 occurred<sup>1</sup>, there was no time limit on participants’ ability to review final prices. As a result of that event it was determined that prices needed to be made final within a</p>

<sup>1</sup> This event occurred after Transpower discovered a metering error on the Penrose and Mt Roskill GXP’s – the meters had been under-recording for an extended period spanning several years. When the error was corrected, and the corrected volumes were entered into SPD, it was found that the wholesale market prices lifted materially. At that time, prices were not final (as they are today), so several years of wholesale market prices were recalculated and rebilled, leading to a material increase in costs to loads.

	<p>few days of the trading day itself.</p> <p>7.3 However, the market and/or Electricity Commission had the ability to delay the issuing of final prices. This gave a very short period for participants to ensure they were happy with the resulting prices. UTSs were called as a mechanism to ensure prices did not go final. Subsequently, the Authority decided to give itself the power to change final prices, but with a lack of clarity over the term of this ability.</p> <p>7.4 TrustPower does not believe the industry would want to have an underlying “Penrose” event reoccur simply because the industry has forgotten why it collectively decided to ensure prices went final within a few business days of trading day.</p>
<p>8. 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.</p>	<p>8.1 No. This amendment is only required because the Authority seeks to extend its jurisdiction outside the spot market. TrustPower does not consider a case has been made for an extended jurisdiction for the reasons already outlined in the answers to previous questions.</p> <p>8.2 The Authority’s proposal involves a number of risks for market participants. For example, there is a major risk that two identical contracts could have different consequences depending on the identity of the counterparty (in other words whether or not that party is subject to the Code).</p> <p>8.3 Further, the same set of events will be subject to the jurisdiction of more than one entity.</p> <p>8.4 Finally, the paper does not explain why it is necessary to intervene in the hedge market <i>ex post</i> rather than regulate <i>ex ante</i> for a particular outcome, for example by regulating a requirement for a specific force majeure clause.</p>
<p>9. 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.</p>	<p>9.1 Yes.</p>