

Hi all,

We have some initial questions about some of the information in the UTS claim. Can you please coordinate a response to the following questions (references are to pages in the UTS claim):

1. Please explain why the issues you have identified are unable to be resolved by way of a) enforcement of the existing Code by the Authority, or b) an amendment to the existing Code
2. You allege 'coordinated use of market power' (pages 5, 9, and 10). Do you mean conduct that would be unlawful under the Commerce Act? Or some other standard?
3. You refer to 'significant unutilised reserves' on page 6. Can you please explain what you mean by that phrase.
4. You state that prices are atypical given supply conditions (page 5). Can you please explain this in further detail.

If you have any clarifying questions, please contact Michelle (cc'd) in the first instance.

Kind regards

Rory

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19 November 2018 (by email)

UTS CLAIM

1. This is a co-ordinated response to your questions as requested by email dated 9 November 2018, on behalf of all five claimants.
2. To avoid any confusion regarding the elements of the claim and so as to ensure that the responses appropriately relate to those elements, we set out a summary of the claim and applicable principles first, followed by sections dealing with each response.

THE CLAIM

3. The claim sets out a number of bases for declaring a UTS:
 - (a) By virtue of the co-ordinated exercise of market power (pages 5 - 9 of the complaint) (ie, tacit collusion, which is expanded further below in response to your question 2).
 - (b) The prospect of one of the Authority's stress test scenarios being breached also constitutes a UTS (pages 9 – 10 of the complaint).
 - (c) Contracts market failures (pages 11 – 14 of the complaint).
 - (d) Lack of transparency due to failures to disclose information (pages 14 – 17).
 - (e) A confluence of all these factors (pages 4 – 5 of the complaint).
4. In respect of each item above individually (and, therefore, necessarily in respect of item (e) collectively), both parts (a) and (b) of the definition of a UTS are established. In respect of items (a), (c) and (d), clause 5.1(2)(a) of the Code also applies, and in respect of items (a) (b), (c) and (d), clauses 5.1(2)(e) and (f) apply as well.

LEGAL PRINCIPLES

5. In the High Court decision regarding a UTS in 2011 involving Genesis ([2012] NZHV 238), the Court endorsed (at [96]) the Authority's position that:

- (a) s15 of the Act provided the economic context for interpretation of a UTS and that “the economic rationale of UTS provisions is to achieve operationally efficient and competitive markets” (at [67] to [69]);
- (b) UTS provisions are adopted by market providers because they cannot foresee all future eventualities and hence cater for these in the market’s rules and some practices are particularly difficult to specify in the rules and so are better covered by generic-type UTS provisions (at [90]);
- (c) the inference from clause 5.5 of the Code is that a UTS could not constitute the “normal operation” of the market ([88]);
- (d) “orderly” has a wider meaning that just completion of trades and includes that all market participants would be trading on a “level playing field” ([97]), not with an “imbalance of knowledge about the market” ([98]), and that “market traders be equally well informed of market conditions” ([99]), and [101] to [102], [212];

6. The Court also:

- (a) rejected arguments that UTS provisions were not an appropriate remedy on the basis asserted that what was sought by the claimants was a rule change, and that amendments to the Code could avoid the issue in future ([118(d)], [177]).

The Court said that the Authority must decide whether a UTS exists based on the situation presented, it may not be the case that a rule change was justified, that amendments for the future would not have any effect on that situation and that uncertain amendments in future would not solve a repeat of the situation unless and until amendments were passed ([271], [274], [275]). The Authority is correct to (and is required to) focus on the definition of UTS and the situation presented, and is entitled to conclude that protection of trading in the meantime was required to ensure market confidence;

- (b) rejected arguments that “contingency or event” must constitute a single circumstance, and held that the “words can include a combination of factors and typically will do so” ([119]), that there can be a “variety of circumstances” ([121]) or a “set of circumstances” ([123]).

The decision of the authority, and upheld by the Court, was “based on a combination of circumstances giving rise to the UTS. Each factor considered alone might be within an “ordinary market”...[197] and “the appellants’ analysis considers each issue in isolation from others [198]...but [t]he Authority’s approach was, correctly, to consider all in combination and decide

if the combination of circumstances met the definition of a UTS” [199]. “[A] series of events, some events part of a normal market operation...could in combination be a contingency or event which is a UTS” [256].

Since, and because of, that decision, this point has been made abundantly clear by deleting references to “contingency or event” and referring in the definition now to a “situation”

- (c) all of the circumstances described in the examples of a UTS (hitherto within the definition, but now contained in clause 5.1(2), including the question of public interest, can legitimately be used in interpretation of the two limbs ((a) and (b)) of the definition ([141]);
- (d) exceptional circumstances do not have to exist before a UTS can be declared, but relevantly to a claim is an analysis which shows that the situation is “out of the ordinary or beyond normal trading” ([172]);
- (e) based on the objectives in s15 of the Act, “a competitively and efficiently operated wholesale market [is] in the public interest” ([283]), the “wholesale market” is defined to mean the spot market and the hedge market, but it is also “simply not possible to break up the market for supply of electricity between wholesale and retail...[n]either can function without the other. The retail electricity market is inevitably affected by what happens at a wholesale level...[which] suggests that threats to the public interest, which inevitably would include the retail market for electricity can properly inform the Authority’s assessment in clause (a) of the definition” ([291])

QUESTIONS OF 9 NOVEMBER

7. Your questions are dealt with under the headings below.

1 Resolution by enforcement of other provisions or by amendment of Code?

8. There is not, as far as we are aware, other provisions of the Code that can be enforced in the situation. If there were, we would expect the Authority to do just that.

9. Nor, as the High Court decision in Genesis shows, should the question whether a UTS can be resolved by amendments to the Code be a consideration. We have suggested, in respect of solutions sought, that for the future the Authority should make certain amendments, but they are in no way intended to be taken as a solution to the current situation and the UTS that has occurred.

2 Commerce Act

10. While the Commerce Act could also be breached by the tacit collusion alleged, that is not a necessary condition for determining that conduct exists for the purpose of declaring a UTS.
11. Reference to 'coordinated use of market power' should not be interpreted as the applicants alleging a breach of section 27 of the Commerce Act (reflecting the considerable legal challenges and standards in that jurisdiction when bringing such an action – something that the Authority need not, and should not, be concerned about when assessing whether a UTS has occurred). Whether or not there has been a breach is a matter for that Act and for the Commerce Commission, and the Claim does not invoke clause 5.1(2)(d) of the Code ("material breach of any law").
12. It is not necessary for firms to communicate explicitly in order for them to know what to do in certain situations in order to maximise their joint profitability, i.e., to tacitly coordinate their conduct. There is perhaps no better example of a market with tailor-made conditions for such implicit coordination than an energy-only wholesale electricity market. For example, there is:
 - (a) high seller concentration, leaving fewer businesses whose activities need to be coordinated and monitored;
 - (b) high barriers to entry and expansion, which provide enhanced scope for profitable price increases without a commensurate threat of entry;
 - (c) market transparency whereby price information is widely and readily publicly available such that prices can be easily monitored;
 - (d) price inelastic demand, which allows firms to increase prices without a substantial fall-off in demand;
 - (e) almost no product differentiation where competition is mainly on price, allowing firms to settle more easily upon the appropriate price level without having to deal with variations in quality;¹

¹ Also, Wolak, F., (2005), "*Managing Unilateral Market Power in Electricity*", World Bank Policy Research Working Paper 3691, September 2005, page 4 and Similarly, Twomey, P., R. Green, K. Neuhoff and D. Newbery, (2005), "*A Review of the Monitoring of Market Power*", Cambridge Working Papers in Economics CWPE 0504, page 54: "*There are sound theoretical reasons (and supporting evidence) for suspecting that electricity*

13. Specifically in the current situation, market power is co-ordinated through means which include but are not limited to:
 - (a) changes to bid offer stacks are not a prerequisite given the stacks can be constructed to maximise power in the market when it arises;
 - (b) withholding volume either physically or economically through bid prices when at no time was there less than 40% hydro;
 - (c) all generators knowing each others bid stacks from the previous day
 - (d) all generators receiving the highest offer price. All profiting from a higher spot price even at the expense of some volume
14. It follows that when supply constraints the likes of which we have been and are seeing at the moment emerge, this provides an opportunity for a large gentailer to strategically increase its offers, safe in the knowledge that others will follow suit (and knowing that it will be in a position to react swiftly if they do not). This mutually reinforcing conduct can then drive up spot prices *well above* the levels justified by the supply constraints – but those constraints can nonetheless be used as a convenient excuse to rationalise those increases.
15. This outcome can be achieved without exchanging any phone calls, emails or memoranda. The businesses in question have set prices and quantities thousands upon thousands of times, and through those repeated interactions, know what to look for and how to respond in certain situations.
16. While the distinction between explicit and implicit coordination may be an important practical consideration to a court when adjudicating on a section 27 matter, it is immaterial to the Authority in this context. All the Authority needs to examine is whether the prices have exceeded what is reasonable given the prevailing supply conditions, thereby undermining the confidence in and the integrity of the spot market.

3 Significant Unutilised Reserves

17. The statement “significant unutilised reserves and there have been no security events” is an observation of the lack of threat to security of supply. Indeed during the period there were no Warning Notices (WRN) or Grid Emergency Notices (GEN).

markets may be unusually susceptible at times to the exercise of market power, compared to other markets.”

18. The Authority has access to all the relevant information to assess security of supply including reserves availability and the System Operator security notices.

4 Atypical prices, supply conditions

19. The Authority has access to all the relevant information. The material we have already provided to indicate atypical prices and supply conditions [Pages 5-9], is enough to justify the Authority conducting further investigation.
20. If there is anything further we can help the Authority with, please let us know. We trust, however, that in light of the Claim, the applicable legal principles and our responses in this letter, the authority will now investigate and declare a UTS.

Yours Faithfully,



Luke Blincoe
Chief Executive
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