

Claimed Undesirable Trading Situation **on 26 March 2011**

Leonard E Ward

E - len@tusklegal.co.nz

M - 021 402 048

T - 09 367 1033

7 April 2011

Privileged and Confidential – Provided in contemplation of legal proceedings

1. Introduction

- 1.1 This confidential report has been prepared on the basis of information provided to me by Mighty River Power Limited. That information was primarily in the form of a confidential report commissioned from Sapere Research Group (Kieran Murray and Toby Stevenson, in particular) together with certain relevant excerpts from the Rules of NZEM, The Electricity Participation Code 2010 and the Electricity Authority Guidelines for Participants on Undesirable Trading Situations (version 2.1).
- 1.2 This confidential report is provided to me in my capacity as a commercial consultant. I am not providing legal advice on this matter.
- 1.3 I have not been engaged as an expert witness in this matter but believe that I am qualified to provide an opinion on the following basis.
 - (a) Before migrating to New Zealand I was engaged professionally in trading on the markets of the London Metal Exchange and the various soft commodity markets of the London Commodity Exchange (Sugar, Coffee & Cocoa).
 - (b) I was Chairman of New Zealand Commodities Market Limited from 1979 to 1984 and was deeply involved in the establishment in New Zealand of a market for the trading of wool futures under the auspices of the London Wool Terminal Market Association (later re-named the London, New Zealand Futures Association) and for developing the world's first fully computerised fully functioning futures & options exchange, the New Zealand Futures & Options Exchange.
 - (c) I was the inaugural Chief Executive and Managing Director of the New Zealand Futures & Options Exchange from its inception in 1984 until I resigned in early 1993.
 - (d) I was CEO of the derivatives division of the Australian Stock Exchange (ASX) from 1993 to 1995.
 - (e) I was CEO of Pacific Energy Limited, an electricity trading company from 1995 to 1998. During that period I was heavily involved in the development of the wholesale market for electricity in New Zealand (NZEM). I served on the following working groups:
 - (i) The Rules Structure Working Group; and
 - (ii) The Clearing & Settlements Working Group
 and was a Member of the Rules Committee.

 I was Chairman of the MARIA Governance Board and for a brief period was a member of the Appeals Board (although I was not involved in hearing any appeals).
 - (f) From 1999 to 2001 I was a member of the Board of Directors of M-Co Limited.

- (g) From September 1998 to December 1998 I was project director of the Waikato Independent Development Group, responsible to New Zealand Treasury for determining the viability of one of the new SOE's developed from the split of ECNZ.
- (h) I am a practising Barrister & Solicitor of the High Court of New Zealand, practising in commercial/corporate law.

2. **The fundamental importance of rules relating to undesirable situations**

- 2.1 There are certain prerequisites for a successful organised market (often referred to as an 'exchange'). These markets, including NZEM, survive and develop when the participants in them are governed by a series of rules designed to protect the integrity of the market itself with particular regard to:
 - (a) the flow and parity of information;
 - (b) a robust settlements system;
 - (c) avoidance of 'artificial' pricing; and
 - (d) efficiency of the price discovery process.
- 2.2 Another feature of a successful exchange is one where not only are the rules (described above) in place but where there is also a mechanism for and a determination to enforcement of the rules and the provision of sanction for breaches.
- 2.3 Many of the world's exchanges are central to the efficient operation of core parts of the local (or national) economy and there is therefore a public interest in the maintenance of appropriate standards of behaviour, consistent with the underlying principles contained within the rules of the exchange.
- 2.4 For this reason (amongst others) rules governing undesirable situations are invariably at the core of the efficient operation of exchanges. They are incorporated for a variety of reasons including;
 - (a) to protect against market manipulation (and therefore to ensure against 'artificial prices');
 - (b) to provide for flexibility of action in order to ensure a fair or orderly market, including settlement processes; and
 - (c) to deal with exceptional or unforeseen circumstances that threaten the trading principles under which the exchange was established or the public interest.
- 2.5 Participants are attracted to such exchanges precisely because they know that these rules exist and that there is a mechanism in place for the efficient enforcement of them. This enforcement regime invariably incorporates provisions for sanctions against participants who may be found to have breached the rules.

3. **Development of the Rules of the New Zealand Futures Exchange (NZFE)**

- 3.1 The New Zealand Futures Exchange (later renamed New Zealand Futures & Options Exchange) had as its genesis the London Wool Terminal Market Association (later renamed the London New Zealand Futures Association).
- 3.2 In the late 1970's members of the LWTMA (and its clearing organisation - ICCH) visited New Zealand to explore ways in which their New Zealand Crossbred Wool contract could be utilised to a greater extent by New Zealand's wool exporting companies. This was to give rise to the development of the LNZFA – the world's first 24 hour commodity futures contract, traded in London and New Zealand from 1980 until the advent of NZFE in 1985.
- 3.3 The LWTMA had been in existence for many years prior to this time and had a well-established set of rules governing their members (participants) conduct. These rules included rules dealing with undesirable situations and practices.
- 3.4 During the period from early 1984 to early 1985 the rules of the nascent New Zealand Futures Exchange were developed. They were based largely on the rules of the LTMA/LMZFA and on those in operation at the Sydney Futures Exchange.
- 3.5 In my capacity as Chief Executive of NZFE I was the person with primary responsibility to develop the rules and trading processes for NZFE.
- 3.6 The rules of NZFE also included rules related to undesirable situations and practices.
- 3.7 Over the ensuing years the Board and later the Business Conduct Committee of the NZFE were called upon to determine whether or not an undesirable situation or practice had occurred.
- 3.8 During those years the New Zealand financial services sector was characterised by a hands-off approach to financial markets regulation by central Government in favour of a more laissez faire self-regulatory approach. In this regulatory vacuum the rules of the NZFE and especially the undesirable situation or practice rules became the cornerstone under which the NZFE's integrity and acceptance as a fair and orderly market was maintained.

4. **Development of the Rules of the New Zealand Electricity Market (NZEM)**

- 4.1 About a decade later in the mid 1990's the New Zealand Electricity Market was being developed. By coincidence a number of experienced NZFE board members, NZFE executives and NZFE trading members (participants) were integral in developing the NZEM.

- 4.2 I was personally involved in that process as a member of the Rules Structure Working Group and the Clearing & Settlements Working Group of NZEM and later as a member of the Rules Committee of NZEM and later still as a director of M-Co Limited.
- 4.3 I recall that there was a significant emphasis placed on understanding and incorporating into NZEM a number of aspects of the rules of NZFE, including the rules related to undesirable situations and practices. The concern of the architects of the NZEM rules, including myself, was that there could be times, given the relatively small number of market participants expected to be involved in that market, where for reasons of market dominance, ownership of critical generation assets, a transmission network prone to constraints, vertical Integration, and other reasons, one or more participants could engage in behaviour that was not only detrimental to the interests of other participants but that could also threaten the long term viability of the market itself. Any or all of which occurrences would, in my opinion, also have been contrary to the public interest.
- 4.4 For these reason the rules subsequently approved and implemented by NZEM participants included rules related to Undesirable Situations and the definition of Undesirable Situations was sufficiently broad to cover a large number of possible occurrences, including, but not limited to;
- (a) events having the effect of precluding the maintenance of a fair or orderly market or proper settlement of trades;
 - (b) any exceptional or unforeseen circumstance which threaten, or may threaten, just and equitable principles of trading **or** the public interest (*emphasis added*); and
 - (c) manipulative or attempted manipulative activity.
- 4.5 These basic principles are still in evidence in the definitions of Undesirable Trading Situation contained in the Electricity Industry Participation Code 2010 (Part 1).
- 4.6 I note that, in addition to the principles detailed above, the definition of Undesirable Trading Situation in the Code also includes the following:
- (a) *conduct in relation to trading that is misleading or deceptive, or likely to mislead or deceive.*

5. Comments based on a review of the Sapere Research Group reports

- 5.1 I have been provided with confidential copies of papers authored by Kieran Murray and Toby Stevenson of Sapere Research Group and I have been briefed by the General Manager Operations of Mighty River Power Ltd as to the nature of their complaint (UTS) to the Electricity Authority.
- 5.2 I have reviewed those papers in light of my experiences both as CEO of NZFE and as a person responsible, in part, for the development of the Rules of NZEM. In addition, my understanding of the issues raised in those papers is informed by my experiences as a trader in the metals and commodity exchanges of London and as CEO of Pacific Energy Ltd which company was responsible for the purchase and ongoing sale of up to 23% of the output of ECNZ in the few years immediately prior to the disestablishment of ECNZ.

- 5.3 I have assumed that the descriptions of the activities of 26 March 2011 contained in those papers are accurate to the extent that I can reasonably rely on that accuracy in order to form opinions of my own.
- 5.4 I am aware of the general nature of the events of 26 March 2011 from reports in the mass media.
- 5.5 I note that Kieran Murray states that his assessment is necessarily from an economic perspective.
- 5.6 Kieran Murray concludes in his paper that
- (a) *“on the basis of information available to me, the events of 26 March constitute **manipulative trading activity**”; and goes on to say*
 - (b) *“and an exceptional or unforeseen circumstance that is at variance with generally accepted **principles of the public interest**”.*
- 5.7 Toby Stevenson concludes in his paper that – *“On that basis Genesis Energy’s conduct in relation to trading during the event is **misleading or deceptive, or likely to mislead or deceive**.”*
- 5.8 I concur with both sets of conclusions for the reasons given by the authors and in addition for the reasons set out below.
- 5.9 Moreover I also conclude that the activity of 26 March was an Undesirable Trading Situation in that it was an exceptional or unforeseen circumstance that is at variance with, or that threatens or may threaten, generally accepted **principles of trading**.

6. Summary and Conclusions

- 6.1 In my opinion market prices were **manipulated** on 26 March for the following reasons:
- (a) From the information provided to me and from my knowledge of how the NZEM market for wholesale electricity prices works I conclude that, in this instance, Genesis Energy was aware, or ought to have been aware, that it had the capacity to determine the price for wholesale electricity for most, if not all, of the entire period of the planned outage.
 - (b) It chose to adopt a bidding strategy that not only failed to signal, to the market as a whole, the level at which it would ultimately determine those prices but it also did set those prices at a level so artificially high as to have no relationship with historic price levels in a reasonably mature market with many hundreds of thousands of prices having been established over the years since the inception of NZEM.
 - (c) In my opinion this was done deliberately and with the intent of causing disruption to the orderly functioning of the wholesale market for electricity in New Zealand.
- 6.2 In my opinion pricing outcomes of 26 March do not reflect scarcity and are at variance with generally accepted principles of **the public interest** for the following reasons:

- (a) From the perspective of a market operator (NZEM in this instance) public interest is a vital ingredient in the success or otherwise and the ongoing viability of the market. If the public has no confidence in the ability of the market to clear prices at what are reasonable levels, given the circumstances of the period in question, not only do participants face potential loss but the market as a whole faces a loss of confidence. This loss of confidence in NZEM would have serious public interest repercussions, including, but not necessarily limited to;
 - (i) possible intervention by relevant authorities including, central Government, in the pricing of electricity in the wholesale market;
 - (ii) lessening of the efficacy of price discovery leading to a rise in wholesale prices and the resulting rise in retail prices;
 - (iii) the need to reconsider the underlying principles upon which NZEM was established and the possible consequences of the market being reshaped or disestablished.
 - (iv) the resulting lessening in the inherent value of energy companies as a result of an uncertain operating environment; and
 - (v) the consequential negative impact on investment in new generation assets in New Zealand leading to future security of supply issues.

6.3 In my opinion Genesis Energy's conduct in relation to trading during the event is misleading or deceptive, **or likely to mislead or deceive** for the following reasons:

- (a) The bidding strategy adopted by Genesis Energy the day before the event and the day of the event was not a strategy that gave good signals to market participants that a price for spot wholesale electricity orders of magnitude greater than anything the market had seen before since its inception in 1995 would be the outcome.
- (b) One price forecast at 12.45pm on Friday for Otahuhu at \$20,000/MWh which was not repeated until 10.30am the next day when the outage actually occurred does not constitute an effective signal of Genesis's intent to determine that price for the duration of the outage.
- (c) The failure to continue to forecast prices at the historically high levels which ultimately prevailed is therefore conduct which Genesis knew, or ought to have known, was likely to mislead or deceive other market participants. Genesis appeared to do nothing to mitigate this likely deception.

6.4 In my opinion the activity of 26 March was an Undesirable Trading Situation in that it was an exceptional or unforeseen circumstance that is at variance with, or that threatens or may threaten, **generally accepted principles of trading** for the following reasons:

- (a) Prices on exchange traded markets around the globe tend to move up and down in reasonably small increments. Even in the most volatile of markets (and I note here that spot electricity markets are amongst the most volatile) movements of more than a few percentage points are relatively uncommon. In the case of spot electricity markets like NZEM prices do vary widely from time to time in response to changes in factors such as lake hydrology and other climatic changes affecting the supply/demand equation.

- (b) Many exchanges, recognising the real problems caused by massive movements in one direction or the other, place restrictions of the degree to which prices may move in any particular trading period (normally price moves are limited to a certain relatively small extent above or below the closing price of the day before).
- (c) These limits on price movements not only allow for a cooling off period but they also provide time for those participants facing loss to secure the necessary funding to cover their positions in the markets (paying margin calls).
- (d) In almost every market in the world prices are set by the interaction of willing buyers and willing sellers and are a reflection of the supply and demand for the product or service in question at any given time.
- (e) However, notwithstanding the inherent volatility of spot electricity markets, including NZEM, in my view a price of \$20,000/MWh is far outside the norm, in absolute terms as opposed to being a measure of volatility per se, as it is so much higher than had ever been seen before in the history of NZEM. That this price was set at a time when there was, in fact, no shortage of supply must, in my opinion threaten generally accepted principles of trading.

Leonard E Ward
Email len@tusklegal.co.nz
M 021 402 048
T 09 367 1033

7 April 2011