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To Whom It May Concern

UTS on 26 March 2011 - Cross submission in response to Submissions made 13 May 2011

Thank you for the opportunity to make a cross submission in response to the submissions published on the Electricity Authority (EA) website regarding the alleged Undesirable Trading Situation (UTS) on 26 March 2011.

In our opinion, there is nothing in the submissions that should cause the EA to alter its fundamental conclusions in the draft decision that: (1) there was a market squeeze by Genesis, and (2) a market squeeze constitutes a UTS.

Furthermore, we do not believe any of the submitters' comments on remedial actions materially alters the positions we have set out in our submission and supporting expert evidence. In our opinion, the submissions only reinforce the arguments within our submissions.

A further expert report by Kieran Murray and Toby Stevenson of Sapere is submitted with this cross-submission. This report carefully and specifically refutes the primary assertions made by Genesis in its submission and in the Castalia evidence appended to it.

The integrity of the wholesale electricity market, and consequently, the growing derivatives market, is the paramount consideration that we have addressed in our submissions and this cross submission, and those of our experts.

There are several points we would like to emphasise, particularly drawing on experience in the post 26 March period:

1. Genesis' post-event conduct and the nature of their submissions (and those of other parties including Contact Energy and Todd Energy) elevates the importance of the final decision of the EA in establishing boundaries for acceptable behaviour and improvements in the Code regarding the appropriate objectives, incentives and penalties for market participants.
    a. We are concerned that Genesis (and potentially other market participants judging by their submissions) appear to believe that it is justifiable to substantially differentiate offering behaviour around a transmission constraint from typical behaviour outside the constraint, to orchestrate becoming net pivotal (and/or not seek to amend offers once a net pivotal position results), charge whatever price it likes in the wholesale markets (and by extension hedge markets) and to somehow think that this doesn't constitute a UTS.
    b. Genesis seeks to explain and rationalise this position by reference to the weak economics of maintaining availability of its aging Huntly units but these units did not in fact set the price during the UTS. The market squeeze was implemented by modifying offers on its low-cost and efficient e3p CCGT. Irrespective of commercial considerations around the age and/or cost of particular plant, the integrity of the wholesale electricity market must be a much more primary consideration for participants and consumers that are totally dependent on its orderly functioning.
    c. The market has been told repeatedly by Genesis that the commercial viability of the aging Huntly units, which are suffering significant utilisation declines due to the commissioning of modern technology by Genesis themselves at e3p and by competitors, depends on securing long term contracts for these plants to be

called on to provide "dry year" reserves. Paradoxically Mighty River Power has recently agreed such a multi-year contract but the terms of this contract provide inefficient and ineffective protection against short term transmission constraints when Genesis is net pivotal. We agree that the old Huntly's future is tied to these forms of "dry-year" reserve contracts, but do not agree that Genesis or any other generator should be able to exploit short term transmission constraints to charge whatever it likes either in the wholesale or hedge markets as a means to artificially boost returns across their portfolio or for an individual station. If the units cannot secure sufficient contracts they should be closed and replaced by modern equipment (as is happening) or sold to parties who can generate better returns.

d. We note that day ahead offers from Huntly on 13 May for the period of Saturday 14 May, when a similar transmission constraint existed, were temporarily offered at matching extreme levels to those that were offered on 26 March. Providing a pattern of extreme offering behaviour around constraints by a participant when it is likely to be in a net pivotal position should not of itself constitute appropriate market notice nor nullify conditions for determining a market squeeze and a UTS. It must be undesirable to squeeze the market during a physical transmission constraint by modifying prices to take advantage of a net pivotal position. Genesis appears to be attempting to set a pattern of conduct to demonstrate that this type of behaviour is somehow "acceptable". We consider the EA needs to specifically reference this behaviour through its final decision and subsequent modifications to the Code, which could also include the ability for the EA to execute more immediate post-event EA decisions.

e. We strongly disagree with Genesis' submission that future retail prices would be unaffected if the squeeze on 26 March is not unwound and becomes permitted behaviour in the market. What keeps downward pressure on retail prices is competition, which was the substantial driver behind the many outcomes of the Electricity Industry Act 2010. During times when one party can become net pivotal in a constrained region purely through its own actions and without sanction, there is no short term supply side competition and consequently no competition for the supply of hedges. The net pivotal party can squeeze the wholesale and hedge markets in the region, behaviour which we have seen both during and subsequent to 26 March. The squeeze behaviour does lead to higher costs in the region (whether through wholesale or hedge market outcomes) which must through time be recovered from consumers in that region (in this case all customers north of Hamilton). If prices do not reflect these increased costs (a situation that could only occur by, for example, Genesis subsidising the market to the north of the constraint), then other retailers will be forced to only retail close to generation assets, which will further limit competition. This is not in the long term interests of consumers, may breach Section 36 of the Commerce Act and would result in inefficient economic outcomes.

f. Extraordinarily, in its submission, Genesis makes the following statement: *The week following 26 March 2011 saw rational and prudent hedging activity and demand-side management and as a direct consequence, benign spot market outcomes.* We strongly disagree with this statement. The hedging activity was undertaken in part because the wholesale market was operating under the uncertainty created by the previous weekend's events. The trading conditions could only be classed as abnormal until the UTS decision is final, and clear signals are set for the wholesale market to operate in an orderly and efficient manner. We surmise this also misstates the position from the perspective of many other market participants. In our view the hedging that did take place was predominantly driven by the fear that the manipulative trading behaviour seen on 26 March would re-occur. Other parties (Wallace Corporation is an example) chose not to operate their manufacturing plants rather than risk exposure to a second event. This is hardly an example of rational and prudent demand side management operating in the broader interests of the New Zealand economy.

2. We do not believe that a price reset following the removal of squeeze offer behaviour sets a floor or cap in the market under normal (and not undesirable) trading conditions. It only sets a clear precedent with respect to undesirable trading. The fact that high prices by themselves do not constitute a UTS is very clear in the EA's draft decision.

3. Similarly, we do not believe that investment signals for peaking plant are dampened by a price reset since business cases should not be based on undesirable trading behaviours in the first place. Undesirable trading is not part of genuine market volatility.
4. We do have some sympathy, again in the interests of an orderly and efficient wholesale electricity market, for the position of some market participants who have taken very reasonable decisions on 26 March but would be potentially penalised by a price that is reset to a lower level than interim prices. However, the core logic of the price reset must take precedence as it critically establishes acceptable behaviour around net pivotal positions. This does again highlight that the market tools that are currently available to the EA to deal with and remedy a UTS are limited and need to be further developed by the EA to ensure that appropriate behaviour is incentivised and inappropriate conduct is penalised.

Finally, while it would be easy and simplistic to deduce that the positions represented by market participants and end consumers in regard to the UTS are solely correlated to their financial exposures to the events on 26 March, we believe that the much more fundamental issue is that the regulatory system for the electricity market is seen to be effective, and has boundaries of acceptable behaviour that will give confidence to participants, consumers and investors.

Transmission constraints by their very nature are potentially dysfunctional to a market since they limit competition, a fundamental underpinning of the market. Behaviour by market participants to squeeze the market under transmission constraints exploits the physical constraint (limits competition), forces participants to take insurance products (hedges) that are only available from the "squeezer" with no limits on prices other than potentially what the "squeezer" has previously offered but not secured. Such a position exposes New Zealand's electricity market to potential international ridicule.

None of the information in our cross submission or that of our experts is confidential.

Please do not hesitate to contact either myself or Fraser Whineray, GM Operations, should further clarification be required.

Yours sincerely

Doug Heffernan

Chief Executive