Meeting date: 26 June 2018

Trading conduct review: draft problem definition

Market Development Advisory Group

Alistair Dixon, Principal Adviser Market Design

Introduction

This presentation sets out a preliminary problem definition for the trading conduct review based on:

- Feedback from the MDAG regarding scenarios that may raise issues regarding trading conduct
- MDAG's consideration of discussions held to date with market participants regarding trading conduct

Reminder of scope of project (A)

a) Trading conduct affecting outcomes in the energy and reserves markets in the New Zealand wholesale electricity market (spot market)

b) considering whether the trading conduct provisions in clauses 13.5A and 13.5B of the Code are adequate or whether changes are required to better promote outcomes consistent with workable competition

c) considering options, including guidelines, to aid in the interpretation of ‘high standard of trading conduct’ in clause 13.5A of the Code

continued on next slide ….

Reminder of scope (B)

continued from previous slide ….

d) in light of any proposals to assist with interpreting ‘high standard of trading conduct’, considering whether the safe harbour provisions in clause 13.5B should be modified to ensure that behaviour of parties operating within the safe harbour is consistent with a high standard of trading conduct

e) considering whether the trading conduct provisions should be broadened to apply to parties not subject to offer requirements but whose actions can impact on spot market outcomes inconsistent with workable competition, or whether it would be preferable to address this by other means, such as amending other Code provisions

f) considering whether the trading conduct provisions should apply to actions other than offers that can impact on spot market outcomes inconsistent with workable competition or whether it would be preferable to address this by other means, such as amending other Code provisions.

Trading conduct provisions

The trading conduct provisions in the Code are as follows:

13.5A Conduct in relation to generators' offers and ancillary service agents' reserve offers

(1) Each **generator** and **ancillary service agent** must ensure that its conduct in relation to **offers** and **reserve offers** is consistent with a high standard of trading conduct.

(2) Subclause (1) applies when—

(a) a **generator** submits or revises an **offer**; or

(b) an **ancillary service agent** submits or revises a **reserve offer**.

13.5B Safe harbours for clause 13.5A

(1) A **generator** complies with clause 13.5A if—

(a) the **generator** makes **offers** in respect of all of its generating capacity that is able to operate in a **trading period**; and

(b) when the **generator** decides to submit or revise an **offer**, it does so as soon as it can; and

(c) in the case of a **generator** that is **pivotal**,—

(i) prices and quantities in the **generator's offers** do not result in a material increase in the **final price** at which **electricity** is supplied in a **trading period** at any **node** at which the **generator** is **pivotal**, compared with the **final price** at the **node** in an immediately preceding **trading period** or other comparable trading period in which the **generator** is not **pivotal** at that **node**; or

(ii) the **generator's offers** are generally consistent with **offers** it has made when it has not been **pivotal**; or

(iii) the **generator** does not benefit financially from an increase in the **final price** at which **electricity** is supplied in a **trading period** at a **node** at which the **generator** is **pivotal**.

(2) A **generator** does not breach clause 13.5A only because the **generator** does not comply with subclause (1).

Trading conduct provisions

Trading conduct provisions continued:

13.5B Safe harbours for clause 13.5A

(1) A **generator** complies with clause 13.5A if—

(a) the **generator** makes **offers** in respect of all of its generating capacity that is able to operate in a **trading period**; and

(b) when the **generator** decides to submit or revise an **offer**, it does so as soon as it can; and

(c) in the case of a **generator** that is **pivotal**,—

(i) prices and quantities in the **generator's offers** do not result in a material increase in the **final price** at which **electricity** is supplied in a **trading period** at any **node** at which the **generator** is **pivotal**, compared with the **final price** at the **node** in an immediately preceding **trading period** or other comparable trading period in which the **generator** is not **pivotal** at that **node**; or

(ii) the **generator's offers** are generally consistent with **offers** it has made when it has not been **pivotal**; or

(iii) the **generator** does not benefit financially from an increase in the **final price** at which **electricity** is supplied in a **trading period** at a **node** at which the **generator** is **pivotal**.

(2) A **generator** does not breach clause 13.5A only because the **generator** does not comply with subclause (1).

Trading conduct provisions

Trading conduct provisions continued:

13.5B Safe harbours for clause 13.5A

.

.

.

(3) An **ancillary service agent** complies with clause 13.5A if—

- (a) the **ancillary service agent** makes **reserve offers** in respect of all of its capacity to provide **instantaneous reserve** that is able to operate in a **trading period**; and
- (b) when the **ancillary service agent** decides to submit or revise a **reserve offer**, it does so as soon as it can; and
- (c) in the case of an **ancillary service agent** that is **pivotal**,—
  - (i) prices and quantities in the **ancillary service agent's reserve offers** do not result in a material increase in the **final reserve price** in a **trading period** in an **island** in which the **ancillary service agent** is **pivotal**, compared with the **final reserve price** in the **island** in an immediately preceding **trading period** or other comparable **trading period** in which the **ancillary service agent** is not **pivotal**; or
  - (ii) the **ancillary service agent's reserve offers** are generally consistent with **reserve offers** it has made when it has not been **pivotal**; or
  - (iii) the **ancillary service agent** does not benefit financially from an increase in the **final reserve price** in a **trading period** in an **island** in which the **ancillary service agent** is **pivotal**.

(4) An **ancillary service agent** does not breach clause 13.5A only because the **ancillary service agent** does not comply with subclause (3).

Reminder of scenarios that have been discussed

MDAG discussed whether the following were consistent with a high standard of trading conduct:

- Raising an offer price to avoid a constraint / a price difference between locations
- Raising an offer price to deal with expected fuel scarcity
- Using engineering factor co-efficients to affect offer
- Offering plant that is in practice not available, eg because of maintenance
- Not informing market that plant is not available
- Withdrawal of plant not subject to offer provisions after gate closure
- Co-ordination of offers across multiple plant
- Offering / grouping of offers on behalf of others
- Not offering all available plant or capacity

Draft problem definition: summary

- The following table summarises the preliminary draft problem definition:

	Problem
1	The general requirement for a ‘high standard of trading conduct’ is considered unclear
2	The trading conduct provisions only apply to parties making offers
3	The trading conduct provisions do not prevent withdrawal of plant not subject to gate closure
4	There are divergent views on whether the trading conduct provisions apply to a party altering its offers to avoid a constraint
5	The trading conduct provisions do not make clear that offers should reflect the underlying physical capability of the plant
6	The trading conduct provisions do not make clear that: • plant should be offered unless it is not available because of bona fide reasons • where plant is not available, the market should be informed, eg by informing the market through POCP
7	The trading conduct provisions do not specifically address co-ordination of offers between generators or ancillary service agents – the Commerce Act may mean this is unnecessary

Draft problem definition 1: General requirement is considered unclear

- By itself, the requirement in clause 13.5A(1) that “Each generator and ancillary service agent must ensure that its conduct in relation to offers and reserve offers is consistent with a high standard of trading conduct” is considered unclear by participants
  - Arguably, this is by design
  - It can be argued that the meaning of a “high standard of trading conduct” has to be inferred from the safe harbour provisions under clause 13.5B and the requirement for the Code to be consistent with the Authority’s statutory objective
  - the safe harbour provisions suggest that the general requirement for a high standard of trading conduct relate to both:
    - matters addressed by the UTS provisions, including market manipulation, deceptive behaviour, unwarranted speculation etc – see clauses 13.5B(1)(a) and (b); 13.5B(2)(a) and (b)
    - the exercise of market power – see clauses 13.5B(1)(c) and 13.5B(3)(c)

Draft problem definition 2: The provisions only apply to parties making offers

- The trading conduct provisions only apply to generators and ancillary service agents making offers in the spot and reserves markets
- However, behaviour by other parties can also lead to spot market outcomes inconsistent with workable competition, eg distributed generation not subject to offer provisions
  - For example, if these parties withdrew plant before a trading period it could in some situations have a material effect on spot market outcomes

Draft problem definition 3: Withdrawal of plant not subject to gate closure

- The trading conduct provisions do not prevent withdrawal of plant not subject to gate closure
  - Gate closure only applies to parties that must make offers but small plant (less than 10-30MW) are not subject to offer requirements
  - However, spot market and reserve market outcomes can be affected by withdrawal of small quantities
  - Co-ordinated withdrawal of multiple small plant can have a material effect on spot and reserve market outcomes, both prior to and after gate closure
  - As noted in slide 11, parties not subject to offer requirements are not subject to the trading conduct provisions because they only apply to generators and ancillary service agents in making offers
- Arguably, this is a specific example of draft problem 2

Draft problem definition 4: Application of provisions to avoidance of constraints

Divergent views on whether the trading conduct provisions apply to a party altering its offers to avoid a constraint:

- One perspective: all participants should manage basis risk with financial instruments and, if necessary, bear the cost directly, irrespective of whether they have the ability to avoid the constraint with their assets
- Another perspective: those with assets should be able to use their assets to manage basis risk, particularly if this is to avoid a loss
- Another perspective: ‘horses for courses’: if financial instruments are available, then should not use assets to avoid constraints; otherwise OK to use assets to avoid constraints

Question: Which is most consistent with promoting the long-term benefit of consumers?

Management of constraints good and bad for consumers

Advantages:

- Can avoid security issues in some circumstances
- Promotes efficient entry of and investment in generation in the long run
- Makes transparent the cost of the operation of the current system

Disadvantages

- Forces costs of managing basis risk onto consumers
- Increases consumers’ hedging costs
- Undermines FTR and futures and options markets
- Causes inefficient curtailment of load

Draft problem definition 5: use of engineering factors to affect offer

- There is a lack of clarity in the trading conduct provisions that offers should reflect the underlying physical capability of the plant
  - This is not specifically addressed by the general provisions (clause 13.5A) or the safe harbour provisions (clause 13.5B)

Draft problem definition 6: Availability of plant

There is a lack of clarity in the trading conduct provisions that:

- plant should be offered unless it is not available because of bona fide reasons such as maintenance
- where plant is not available, the market should be informed, eg by informing the market through POCP
  - This is not specifically addressed by the general provisions (clause 13.5A) or the safe harbour provisions (clause 13.5B)

Draft problem definition 7: Co-ordination of offers across parties

- Sections 27 and 28 of the Commerce Act 1986 prohibits contracts, arrangements, or understandings, or covenants that substantially lessen competition
- The trading conduct provisions do not specifically address co-ordination of offers between generators or ancillary service agents that would have a detrimental effect on spot and reserve market outcomes – the Commerce Act provisions may mean this is not necessary

Draft problem definition: summary

- The following table summarises the preliminary draft problem definition:

	Problem
1	The general requirement for a ‘high standard of trading conduct’ is considered unclear
2	The trading conduct provisions only apply to parties making offers
3	The trading conduct provisions do not prevent withdrawal of plant not subject to gate closure
4	There are divergent views on whether the trading conduct provisions apply to a party altering its offers to avoid a constraint
5	The trading conduct provisions do not make clear that offers should reflect the underlying physical capability of the plant
6	The trading conduct provisions do not make clear that: • plant should be offered unless it is not available because of bona fide reasons • where plant is not available, the market should be informed, eg by informing the market through POCP
7	The trading conduct provisions do not specifically address co-ordination of offers between generators or ancillary service agents – the Commerce Act may mean this is unnecessary

Recommendation and next steps

It is recommended MDAG:

a) **request** the secretariat draft a paper that details MDAG's preliminary view on the problem definition for discussion at the MDAG's August 2018 meeting