

Trading conduct review: problem definition and possible options

Market
Development
Advisory Group

Note: This paper has been prepared for the purpose of updating the Market Development Advisory Group. Content should not be interpreted as representing the views or policy of the Electricity Authority.

For MDAG meeting on 26 February 2019

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Outline

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Key decisions

- Which categories of unwanted behaviours are we seeking to prohibit?
- For each target category, what are the policy and operational elements (or characteristics) in the wholesale market that define the boundary between acceptable and unacceptable behaviour?
- Which legal tools will best establish these boundaries? This is a task for expert legal advisers to work out how drawing on a menu of tools, including:
 - A general HSTC-type standard
 - An HSTC defined
 - An HSTC + safe-harbour +/- guidelines
 - Provisions targeting a 'family' of unwanted behaviours
 - Provisions targeting particular category or type of unwanted behaviours



General
to
specific

Background

Purpose

To set out a more comprehensive framework for the problem definition, remedial options, and evaluation –

- To guide discussion at the MDAG's next meeting; and
- To frame the drafting of the MDAG's next round of consultation with market participants

Project description

The project description is:

“Review of trading conduct provisions in light of events that have tested these provisions. Take into account any findings from case studies, performance reports and compliance reports.”

The aim for the project is:

“To ensure the trading conduct provisions are effective in promoting outcomes consistent with workable competition.”

Origin of HSTC provisions

- In 2012, the Authority asked WAG to consider issues relating to pivotal supplier situations. (Pivotal is explained in Appendix A)
- WAG did not identify any specific efficiency losses arising from local or wider pivotal situations; however, WAG's analysis indicated "potential for material efficiency losses to arise in some scenarios".
- Given the uncertainty as to the extent of potential efficiency losses, WAG advised that any change should:
 - Have a relatively low risk of unintended consequence,
 - Be flexible, and
 - Relatively easy to reverse.
- WAG recommended a "high standard of trading conduct" provision ('HSTC') for generators and ancillary agents with a pivotal position at an island wide or national level.
- The Authority decided that the HSTC provision should apply to all parties making offers.

Origin of HSTC provisions *(cont'd)*

- As the Authority states in its 2017 Meridian decision: “the high standard of trading conduct provisions were introduced to improve the efficiency of prices in pivotal supplier situations”.
- However, instead of promulgating a set of provisions targeted at pivotal supplier situation, WAG and the Authority opted for an unusual combination of:
 - A ‘motherhood and apple pie’ standard with broad application – “high standard of conduct” – which is poorly defined at law and uncertain in its scope and practical effect in this market; and
 - A specific carve-out (safe-harbour) relating to a narrow aspect of but one dimension of trading behaviour.
- WAG seems to have assumed that this option satisfies its three criteria (previous slide). However, WAG does not seem to have undertaken any detailed analysis of its likely scope or effect, in law or practice.

Origin of HSTC provisions *(cont'd)*

- It was intended that the scope, meaning and application of this HTSC mechanism would become better defined over time as it is applied to specific cases and a body of enforcement decisions evolves
- In other words, the boundaries and effect of what is a very broadly worded standard (HSTC) are to be determined by a process of incremental interpretation and application by the Authority, the Rulings Panel and (ultimately) the courts.
- Since the HSTC provisions were promulgated, there have been two compliance investigations, both of which related to alleged misuse of a pivotal position.

Enforcements to date

Meridian case of 2 June 2016:

- The Authority's Board held that:

“Meridian used its pivotal position to cover its unhedged risk.., which essentially resulted in the cost of the risk being met by other parties. The high standard of trading conduct provisions were introduced to improve the efficiency of prices in pivotal supplier situations and the Board would have expected Meridian to have adopted more responsible trading behaviour, either by covering its risk using other available risk management products or bearing the cost of the risk if it eventuates”
- The Authority's Board also noted that:

“Meridian may have relied on its offering strategy to manage the risks it was facing as a result of limitations in the risk management products available in the market”.
- As the Authority's investigator review noted:

“...there may be a **need for further risk instruments** to assist parties to manage their risk”
(emphasis added).
- The Authority decided not to lay a formal complaint with the Rulings Panel but warned that it expected Meridian to meet a higher standard of trading conduct in the future

Enforcements to date *(cont'd)*

Mercury case of 8 December 2016:

- Mercury conducted a 'trial' to understand how other participants would respond to Mercury's reduction of reserves supplied in the context of a national reserve market.
- Unexpected changes in energy and reserve offers by other participants increased the stress on the market, resulting in high final prices for energy and reserves in the North Island.
- The Authority alleged that this trading behaviour was not compliant with the HSTC provisions. After considering the investigator's report, the Authority decided to discontinue the investigation.
- The parties to the investigation requested that the Authority and the industry review the trading conduct provisions

Other cases:

- There have been HSTC cases that relate more to market manipulation where an investigation into a potential breach of the trading conduct provisions was considered but not progressed

Terms of review and initial findings

Brief from Authority

- The Meridian and Mercury investigations gave rise to this review of the HSTC provisions by the MDAG.
- In particular, the Authority asked MDAG to consider –

“whether the trading conduct provisions are adequate to promote the Authority's statutory objective, or whether changes are required to better promote outcomes consistent with workable competition”

Options mentioned by the Authority include:

- Guidelines to aid in the interpretation of HSTC
- Broadening coverage to include parties not subject to offer requirements
- Broadening coverage to include actions other than offers that can impact on the spot market

Meaning of “outcomes consistent with workable competition”

Outcomes consistent with workable competition include:

- Efficient prices – prices reflect opportunity cost of the lowest cost source of supply to meet the next unit of demand
- Barriers to entry and exit not limiting or reducing competition
- A variety of tools or strategies that enable market participants to manage market risks efficiently

Current framework for “workable competition”

- “Workable competition” in the existing wholesale market is a function of:
 - The industry’s structure, in particular neutral and open access to transmission and lines, competing market participants, a neutral system operator;
 - The Electricity Industry Participation Code, governing among other things the wholesale market price discovery process; and
 - Surrounding legislation, including the Commerce Act
- It is a given in any formal market that its rules will not prohibit all forms of behaviour that may be inconsistent with “workable competition”. Rules need to be constantly reviewed to reflect new understandings of market dynamics and innovations in behaviour by market participants.
- The HSTC provisions introduced in 2017 were part of that evolutionary process.
- The Authority’s question to MDAG is whether those provisions are effective “in light of events that have tested those provisions”

Initial findings

- So, in the light of the two cases to date, how well have the HSTC provisions worked in relation to pivotal situations?
- Overall:
 - Questions arose as to the meaning and legal scope “high standard of trading conduct”, and whether Meridian’s behaviour came within the safe-habour;
 - However, the Authority found, in effect, that Meridian’s pivotal pricing behaviour (in the South Island) was not consistent with efficient price outcomes that would have occurred in a situation of “workable competition”;
 - The process of investigation and warning seems to have successfully deterred the offending behaviour;
 - It can be argued, therefore, that the provisions have been effective, and that the first two precedents have been established, which have set initial boundary points in relation to pivotal situations.
- So one option is to leave the HSTC provisions as is and let their boundaries become clearer over time as a body of compliance and enforcement decisions evolves – as was envisioned when the HSTC was introduced.

Problems and risks

However, key problems and risks include –

- The meaning and effect of “high standard of trading conduct” is not clear in general or as it relates to pivotal situations.
- The safe-habour seems to allow unwanted pivotal behaviour.
- In Meridian’s case, the problematic behaviour has been attributed (by the Authority and its investigator) to “limitations in the risk management products available in the market”, so the underlying solution for that situation may have more to do with improving the risk management market than changing the words of the HSTC provisions.
- While the Authority concluded that Meridian’s behaviour was in breach of the HSTC provisions, it is not at all clear how those provisions would be interpreted and applied by the courts, which would start with traditional conventions of statutory interpretation and (most likely) a relatively limited understanding of either wholesale market processes or what “workably competitive outcomes” or “efficient prices” mean in given market situations.

Problems and risks *(cont'd)*

- Further, whether a party's trading conduct is of "a high standard" depends fundamentally on a retrospective judgement of alternative risk management options available to the party under investigation, whether efficient options were available to the party at the time, and whether the party's choice was optimal or reasonable.
- These are judgements:
 - that are often not clear-cut (even in retrospect);
 - about which commercial parties may reasonably disagree; and
 - that the courts are not well equipped to undertake.
- In short, the meaning and effect at a judicial (and practical) level of the HSTC provisions applied to specific cases are relatively unpredictable, particularly given the absence of relevant case law and limitations in comparing the HSTC provisions to analogous provisions in similar markets.

Problems and risks *(cont'd)*

Other more specific limitations in the HSTC provisions as they relate to pivotal situations and offers include:

1	The safe harbours are not available to some plant
2	The safe harbour may shelter and facilitate behaviour inconsistent with a high standard of trading conduct
3	The safe harbour may be difficult to apply in practice
4	The trading conduct provisions only apply to parties making offers
5	The trading conduct provisions do not prevent withdrawal of plant not subject to gate closure
6	The safe harbour allows withdrawal of plant for reasons other than bona fide reasons
7	The trading conduct provisions do not make clear that where plant is not available, but not on outage, the market should be informed, eg through POCP
8	The trading conduct provisions do not make clear that offers should reflect the underlying physical capability of the plant
9	The trading conduct provisions do not make clear that the physical basis for offers should be consistent over time
10	The trading conduct provisions do not make clear that offers by plant with a pivotal position should be consistent with offers under workable competition
11	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
12	The trading conduct provisions do not provide guidance on when re-offering is appropriate

Scope of objectives

Narrow or wider objective?

- We need to start by defining the objective to be achieved. Options follow from a clear definition of the problem to be fixed.
- If the primary objective is (as the Authority put it) “to improve the efficiency of prices in pivotal supplier situations”, another approach would be replace the HSTC provisions with a set of words targeted with more precision and sophistication at pivotal supplier situations.
- This could substantially reduce the risk of market participants and the courts misinterpreting or failing to properly apply the provisions and so increase their effectiveness in discouraging abuses in pivotal supplier situations.

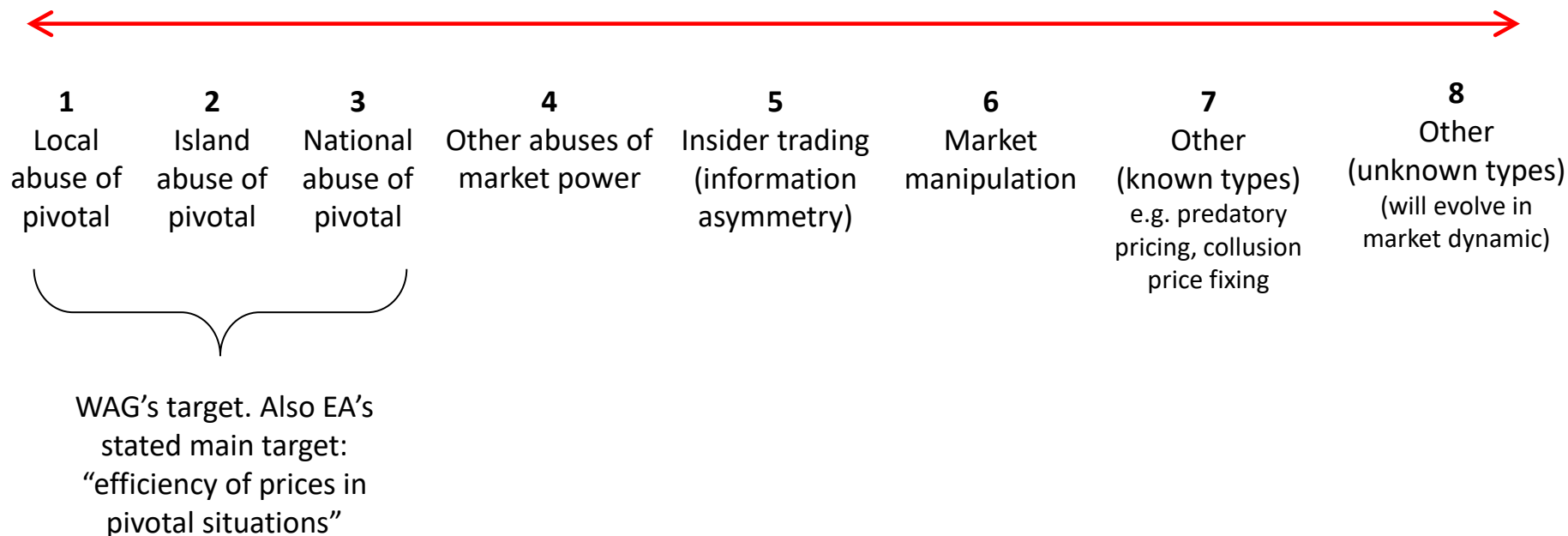
Narrow or wider objective? *(cont'd)*

- On another level, the Authority is interested in using the HSTC mechanism to achieve a wider objective of proscribing other unwanted market behaviours not already circumscribed by existing Code requirements or processes.
- Some of these other unwanted behaviours are of a known type, at least at a general level – like market manipulation, insider trading, misleading trading, and predatory pricing.
- However, other unwanted behaviours are not known but likely to evolve inevitably from innovation among market participants over time.

Narrow or wider objective? *(cont'd)*

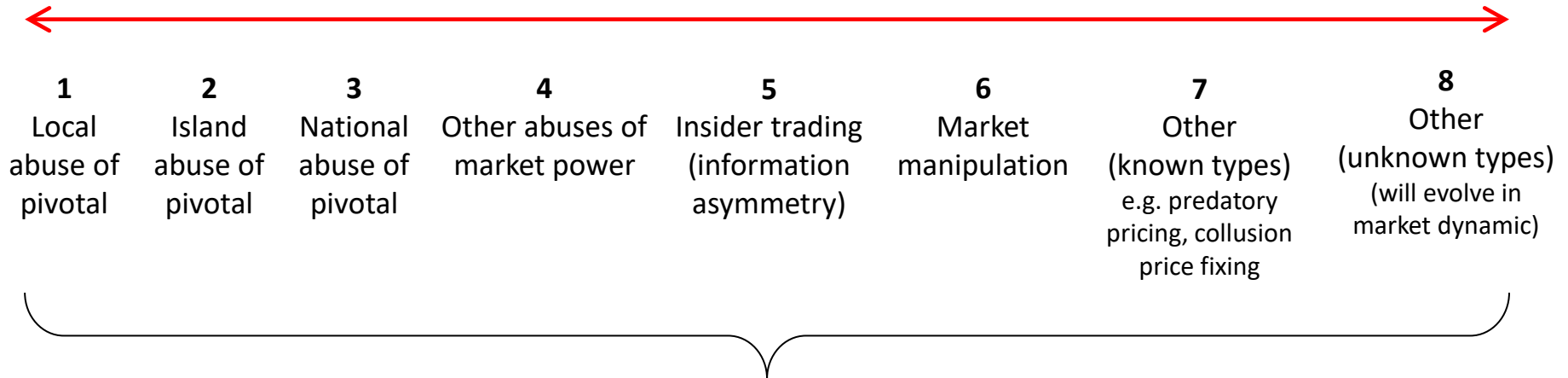
- Extending the objective beyond efficiency of prices in pivotal situations was not analysed in any detail by the WAG or the Authority in the lead up to the 2017 HSTC provisions.
- Nor has the MDAG to date undertaken any analysis on the nature, extent and optimal remedial options for these wider unwanted behaviours in the context of the electricity market.
- It is not at all clear at this stage whether the HSTC provisions are capable of effectively achieving such extended objectives *while at the same time* effectively prohibiting abuses in pivotal situations.
- Indeed, it is not particularly clear that a general HSTC provision prohibits abuses of pivotal situations. At best, the prohibition is inferred by the safe-habour, but this is indirect and the legal implications of not coming within the safe-habour are not clear.

Spectrum of unwanted behaviours*



* Inconsistent with "workable competition"

Ideal code provision

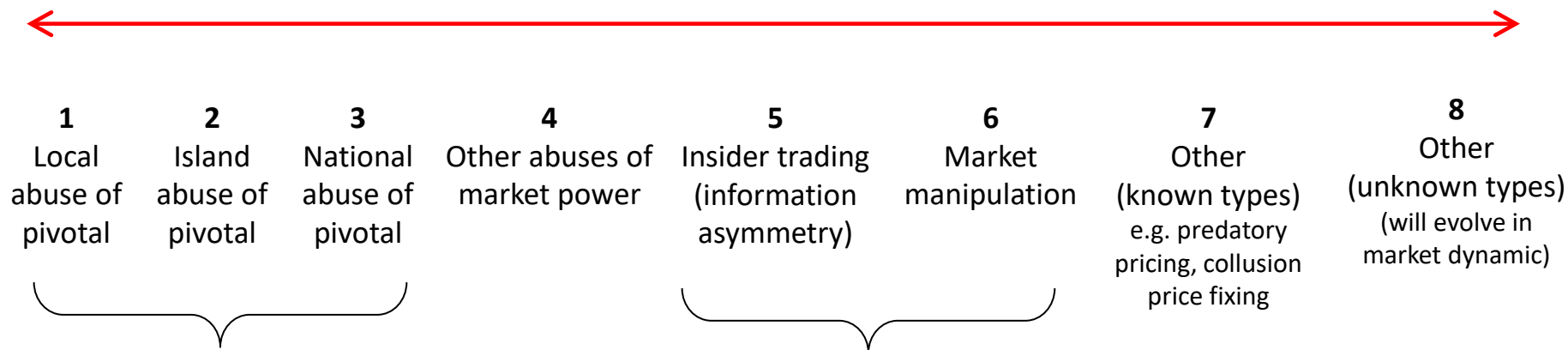


If it were possible, an ideal might be a single, simply worded set of Code provisions that covered the whole spectrum, with sufficient legal clarity that judges and market participants could apply the provisions with a reasonably high degree of certainty, effectively prohibiting each class of unwanted behaviour.

This seems to have become an aspiration for the HSTC provisions.

However, HSTC does not have this legal scope. Nor does it have the necessary definition to effectively prohibit behaviours in categories it may appear to cover at a general level.

Natural legal scope of HSTC provisions



Prohibition on abusing pivotal situations is not necessarily within HSTC, but may be inferred by “safe harbour” provision.

Note also that the relationship between HSTC and UTS provisions is not clear in law or practice

Bell Gully advice provided to MDAG:

The “universals” (core) of HSTC-type provisions are generally –

- Market manipulation; and
- Information asymmetry.

MDAG note – an HSTC may be too amorphous to effectively prohibit abuses in these categories. More targeted prohibitions are used in analogous markets

Understanding each category

- Before proposing an HSTC package, or indeed any other option, to address all or any of these objectives, it is essential to understand each category of problem, how it can occur in the wholesale market, and the potential effect of any existing legal remedies.

Categories 1 – 3:

Abuse of pivotal position

- Pivotal position and potential abuses are outlined at a general level in Appendix A
- A key elements still not adequately defined in the Code or other ‘gaps’:
 - A test for determining when the exercise of a pivotal position amounts to an abuse or unlawful behaviour
 - How to formulate the counterfactual for pivotal parties (ie what the behaviour and/or price would be in a market of “workable competition”), given that in many cases the party is pivotal almost by default.
 - How to determine in real time whether a party is in a pivotal position, given that in many situations it is not clear. In those situations of uncertainty, should the party have to behave as if it is pivotal and apply whatever the Code requirement may be

Category 4 :

Market power abuses other than pivotal

- This is a complex area of law and practice. As economist Donal Curtin points out*:

“...it is universally recognised that it is difficult to define and detect “abuse of market power”, where a firm with market power engages in conduct which damages the competitive process itself. Broad statements of principle leave much room for ambiguity and alternative interpretation; more detailed shopping-lists (in legislation or as case law accumulates) of proscribed practices (eg predatory pricing, exclusive dealing, tying, refusal to deal, 'loyalty' discounts) fare little better, particularly in a world where new tech-based industries give rise to new forms of behaviour that may not be easily categorised”.
- Further, the nature and scope of behaviours that may fall within this category in the context of the New Zealand wholesale electricity market are (extremely) hard to define.
- In addition, definitions of market power in the context of the wholesale market are open to fundamentally different interpretations, which arise from a range of quite different views on the underlying structure of the market and related economic assumptions and models (as shown in the Wolak report in 2009 and subsequent critiques).

Category 4 :

Market power abuses other than pivotal *(cont'd)*

- So it is not entirely clear how the Commerce Act (s.36) impacts on this the wholesale market, particularly in relation to possible claims of market power abuse that might be viewed as an outcome under the Code.
- Relying on a wide “catch all” (eg general prohibition against exercise of market power) in the Code without clarity of the problem to be fixed is unlikely to be helpful.
- In substance, the primary means of mitigating the risk of wider market power abuses are twofold: (i) the existing rules and processes in the Code, particularly in relation to offers and bids and disclosure; and (ii) the structure and organisation of the market.

Category 4 :

Market power abuses other than pivotal *(cont'd)*

- Note that the Government is proposing to change s.36 of the Commerce Act*. MBIE considers that section 36 in its current form does not fully meet the Act's. Their preferred option is to adopt and adapt the Australian law.
- As the ACCC (the Australian equivalent to our Commerce Commission) advised MBIE in 2015 Commerce Act review:^
 - “The current section [36] fails to capture a range of anti-competitive conduct by firms with substantial market power; and
 - “The current purpose test in section [36]...is focused on the impact of the conduct on individual competitors, not on the impact to the competitive process generally. This is inconsistent with the other sections of the CCA and the rationale for having competition laws, which is to protect the competitive process, not individual competitors.”

* “Review of Section 36 of the Commerce Act and other matters”, MBIE, January 2019

^ “Targeted Review of the Commerce Act Issues Paper”, MBIE 2015 - www.mbie.govt.nz/businessand-employment/business/competition-regulation-and-policy/reviews-of-the-commerce-act-1986/targetedreview-of-the-commerce-act-2015/

Category 4 :

Market power abuses other than pivotal *(cont'd)*

- MBIE's proposed changes to s.36 would:*
 - Address the under-reach of the current law and removes the need to construct a hypothetical market;
 - Fit most closely with the general scheme of the Act, which is based on the Australian legislation;
 - New Zealand courts are likely to pay close attention to and often follow the Australian case law, which enhances the body of case law available to New Zealand market participants and helps to improve certainty; and
 - Businesses may operate with a substantial degree of market power in both Australia and New Zealand.
- However, it is not clear whether this would reduce the uncertainties in relation to how s.36 might be applied to the wholesale market.
- In any event, bringing an action under s.36 in network businesses, like electricity and telecoms, is often highly complex, costly and without an obvious answer under the law.

* "Review of Section 36 of the Commerce Act and other matters", MBIE, January 2019

Category 5 : Insider Trading

- Insider trading is another relatively sophisticated form of unwanted behaviour. Its prohibition requires a reasonably sophisticated understanding of how it occurs and the boundaries of when the behaviour becomes unwanted, combined with careful legal definitions and linkages to relevant case law.
- For financial markets, the prohibitions and defences are set out in Financial Markets Conduct Act 2013 ('FMCA') (ss. 234 – 238; and Sub-Part 2, ss 240 – 261).
- The rules of some market – for example the NZX Derivatives Market – incorporate the statutory definitions and require monitoring and reporting by Trading Participants:

(Rule 4.21.1) Each Trading Participant or Advising Participant must have policies and procedures in place for identifying and referring all instances of suspected Insider Trading by a Client to the Compliance Manager or Responsible Executive of the Participant. Each Compliance Manager or Responsible Executive must maintain a written record of all referrals of suspected Insider Trading
- The FMCA is not likely to apply to the electricity spot market. It is not clear that the FMCA covers the FTR market. It may apply to the hedge market. So any prohibition in the Code is more likely to be effective if it is supported by definitions and requirements that identify and proscribe the behaviour in question with a sophistication that parallels laws and practices in precedents like the FMCA, rather than purporting to rely on a general “good conduct” requirement.

Category 6 : Market manipulation

- In financial markets, market manipulation has a dedicated technical definition and covers:*
 - **Disclosure based manipulation** – which typically occurs when a person disseminates false or misleading information which has the effect of misleading other market participants about the value or trading volume of a security. It is prohibited by ss 262 and 264 of Financial Markets Conduct Act 2013 (FMCA), which resembles section 1041E of the Australian Corporations Act 2001;
 - **Trade based manipulation** – which typically comprise the buying or selling of a security by a person that misleads or deceives other participants about the value or trading volume in that security. It is prohibited by ss 265 and 269 of the FMCA, and certain presumptions of such conduct are listed under s. 267, which resemble section 1041B of the Australian Corporations Act 2001.
- The NZX Participant Rules, introduced in May 2004 and updated in April 2015, also contain market manipulation prohibitions applying to NZX Trading Participants, NZX Advising Firms and Advisors. The participant rule dealing with market manipulation is similar to ASX Market Rule 13.4.

* Source: Chapman Tripp, “Stock Market Manipulation Law in New Zealand”, July 2016

Category 6 : Market manipulation* *(cont'd)*

- The FMCA also contains a more general prohibition on **misleading or deceptive conduct** in s.19, which resembles s.1041H of the Australian Corporations Act 2001.
- Unlike the prohibitions in ss.262 and 265, the general misleading conduct prohibition applies to all dealings in securities, including offers for subscription, allotments, underwriting, and anything preparatory to or related to any dealings (such as giving investment advice). The general misconduct prohibition only has civil consequences
- Generally, a breach of the specific market manipulation prohibitions in ss 262 or 265 is also likely to constitute a breach of the ss 19 general misconduct prohibition.

Category 6 : Market manipulation *(cont'd)*

- How market manipulation occurs in the wholesale market compared to financial markets may be similar in concept, but it is likely to be different in several defining ingredients.
- Examples of potential market manipulation in the wholesale market include:
 - Inappropriate withdrawal of plant
 - Lack of transparency about whether a plant is available or not ('purgatory')
 - Incorrect information provided to system operator
 - Structuring of offers to impede or avoid competition or to manipulate other markets
 - Misleading or deceptive conduct – covered by above?
- As with insider trading, any prohibition on market manipulation in the Code is more likely to be effective if it is supported by definitions and requirements that identify and proscribe the behaviour in question with a sophistication that parallels laws and practices in precedents like the FMCA, rather than purporting to rely on a general "good conduct" requirement.

Category 7 :

Collusion and price fixing

- This is another hard-to-define and hard-to-prove behavior in the context of the wholesale market.
- The Commerce Act gives some coverage in relation to price fixing and cartels (s.30), or practices that substantially lessen competition (ss.27+28). However, it's not clear how the boundaries of these laws overlay on the wholesale market.
- Some markets consider behaviour by parties jointly pivotal (eg 3 party pivotal test in PJM).
- In the absence of any analysis on the nature and scope of the potential problem, it is not clear that an amorphous prohibition in the Code would add value.

Category 7 : Predatory pricing

- It has been observed that:⁽¹⁾

“There is no generally accepted definition of the doctrine of predatory pricing, nor is it generally accepted that the phenomenon actually exists.

“In essence, predatory pricing can be described as an extreme form of price discrimination which can be distinguished from legitimate price discrimination in that the reduction in price is undertaken for an anti-competitive purpose. The greatest difficulty in establishing an appropriate test for predatory pricing is that the conduct itself, price reduction, is the quintessence of competition.”

- Predatory pricing cases in NZ⁽²⁾ are almost invariably based on an alleged abuse of market power under s.36 of the Commerce Act:

“...the Australian and New Zealand appellate courts have repeatedly emphasised the paramount nature of the actual elements of the relevant statutory provisions, and in particular the requirement for a proscribed purpose, over any other potentially relevant test”

(1) “Predatory Pricing – The Application of the Doctrine in Australia and New Zealand”, Samantha Sharrif, LLM Research Paper, 1997 - <https://researcharchive.vuw.ac.nz/xmlui/bitstream/handle/10063/5665/thesis.pdf?...1>

(2) eg *Carter Holt Harvey Building Products Group Ltd v Commerce Commission* [2006] 1 NZLR 145 (PC), which went to the Privy Council

Category 7 :

Predatory pricing *(cont'd)*

- In relation to predatory pricing not involving abuse of market power, it has been observed that:^{*}

“[while Australian and New Zealand lower courts have been prepared to utilise relevant elements of the American tests in order to assist in an assessment of whether predation has occurred, they have not been willing to incorporate the doctrine of predatory pricing as having any independent existence outside of the relevant statutory prohibitions on use of dominance for anti-competitive purposes”.
- So uncertainties outlined in previous slides relating to the application of s.36 to the wholesale market also apply in relation to possible actions against potential predatory pricing in the wholesale market

^{*} “Predatory Pricing – The Application of the Doctrine in Australia and New Zealand”, Samantha Sharrif, LLM Research Paper, 1997 - <https://researcharchive.vuw.ac.nz/xmlui/bitstream/handle/10063/5665/thesis.pdf?...1>

Category 8: Yet to evolve

- Other unwanted behaviours are not known but likely to evolve inevitably from innovation among market participants over time.
- These evolutions could be a variants of known categories where the innovation enables the behaviour to elude boundaries or prohibitions in the Code (or elsewhere).
- Or the evolutions could be new and beyond existing categories.
- In any event, the capacity for rules to proscribe known targets and also set a wider net for as yet unknown abuses is extremely challenging as a matter of law.
- Prohibiting these variant or new behaviours is ordinarily best achieved by first analysing the nature and pattern of the abuse, and then designing new mechanisms to effectively target those variant or new behaviours.

High level options

Key question

- A key question for this review is, which categories of unwanted behaviour are we to seek to prohibit in this process?
- With clear objectives, the choice of optimal options becomes a relatively technical issue, trading off a relatively limited range of criteria.

Options at a high level

Given a clear definition of the unwanted behaviours to be addressed, there are four classes of prohibition to consider (in descending order of targeting):

- **Option A: Specific provisions targeted** to counter known abuses, based on clear understanding of scope and effect. Code updated as new abuses or analysis evolves.
- **Option B: Tailored provisions for a category of abuse** 'stretched' – using a set of core provisions across a family of closely related issues.
- **Option C (close to status quo): A broad (amorphous) provision** purporting to cover whole spectrum (like HSTC), supplemented in certain categories by –
 - Carve-outs (safe-harbours), and/or
 - Guidelines

[Note: it is not clear how the Guidelines would work in practice or law in relation to pivotal situations or the Code more broadly. This requires further work. Various Guidelines issued by the Commerce Commission in relation to investigation and enforcement matters may be relevant precedents - <https://comcom.govt.nz/about-us/our-policies-and-guidelines/investigations-and-enforcement>]

Options at a high level *(cont'd)*

A **colourful analogy** to explain the difference between A, B and C is pest trapping in the native bush –

- **Option A** – is the equivalent of a collection of highly specific traps targeted to capture specific pests – a trap for possums, a trap for stoats, a trap for rats (and so on). One type of trap is relatively useless in trapping other types of pests. New designs have to be deployed when new pests are discovered.
- **Option B** – is the equivalent of specific traps for different types of pest, but if one type of trap can be adapted to effectively kill more than one type of pest without compromising the original target pest, then the design is “stretched” (eg a trap that kills both mice and rats)
- **Option C** – is the equivalent of a single all-purpose trap that aims to kill all or most types of pests, including those that may not be known, while achieving kill rates comparable to more pest-specific traps. (Another metaphor is the multi-purpose civic building that is supposed to do all sorts of sport, theatre, live music, orchestra and civic receptions – but usually does none of these very well).

The current HSTC provisions seem to be roughly akin to **Option C**.

Options at a high level



1	2	3	4	5	6	7	8
Local abuse of pivotal	Island abuse of pivotal	National abuse of pivotal	Other abuses of market power	Insider trading (information asymmetry)	Market manipulation	Other (known types) e.g. predatory pricing, collusion price fixing	Other (unknown types) (will evolve in market dynamic)

Option A: Specific provisions targeted to counter known abuses, based on clear understanding of scope and effect. Code updated as new abuses or analysis evolves.

Targeted provision	Targeted provisions + Commerce Act	Targeted provisions	Targeted provisions	Targeted provisions + Commerce Act	Add targeted provisions when problem defined
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Option B: Tailored provision for category of abuse, with provisions 'stretched' to cover any closely related categories

Targeted provisions	"Stretched"	Targeted provisions	Stretched
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Option C: Broad (amorphous) provisions purporting to cover whole spectrum, supplemented for certain categories by safe-harbours and/or guidelines

"Mother and apple pie" provisions with supplements							
Safe-harbour				Targeted provision			
Guidelines							

Options at a high level *(cont'd)*

- **Option D: “Combo” of targeted provisions (A) plus an defined HSTC-type back-stop –**
Put another way:

- Replace safe harbours and guidelines in C with specific provisions in A
- Keep HSTC-type provision
- But make it ‘float’ as an amorphous back-stop across a wider range of the Code, and
- Include a definition of HSTC akin to the “Good Broking Practice” provision in the NZX code or the like –

“Good Broking Practice – conduct that is, at the discretion of NZX, in the wider interests of the markets provided by NZX, the New Zealand securities markets and investors and which complies with the **spirit and intent** of the practices, procedures and requirements as set by NZX” (emphasis added)

Another interesting approach is the Ontario Electricity Market “catch all” rule, which floats across everything in their code:

“R10A.1.1 -...market participants shall not directly or indirectly engage in conduct which they ought reasonably to know “exploits the...administered markets, including by, without limitation, **exploiting any gap or defect** in the market rules” (emphasis added)

- Or define it in terms of each participant behaving as if subject to “workable competition”

Basic trade-offs

Option A - Targeted

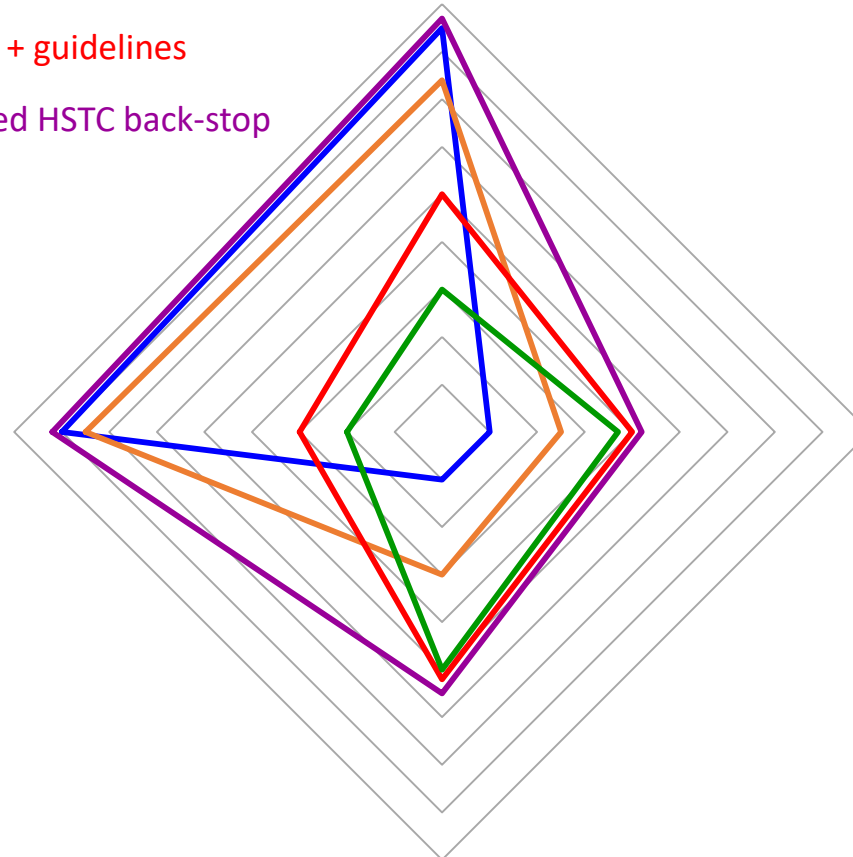
Option B – Targeted + ‘stretch’

Option C – HSTC + safe-harbour + guidelines

Option D – Targeted (A) + defined HSTC back-stop

Option X – HSTC only

High certainty of legal meaning and effect (so more likely to 'trap' unwanted behaviour)



Avoids need to tweak or refine provisions

Good coverage of new or variant abuses (unknown unwanted behaviours)

Avoids need to promulgate new provisions for new or variant abuses

Next step: Specific options

- **MDAG's task** at this level is to define the policy and boundaries indicators of pivotal abuses (or what is not an abuse). Some expert submissions may be relevant (eg Sapere's submission for Meridian, and others yet to be received).
- The **choice of legal tools** to implement these policy and boundary indicators is then primarily an expert technical issue. An analogy is setting the parameters and key concepts for a house design and then handing it to the technical draftsman to turn it into detailed drawings.
- If (say) the aim is to prohibit abuses of pivotal situations, the technical question is, which high level option is likely to be more effective:
 - (i) HSTC + safe-harbour (*status quo*); **or**
 - (ii) HSTC (*new or amended*) + safe-harbour (*new or amended*); **or**
 - (iii) As for (ii) above + guidelines (*new*); **or**
 - (iv) Replace status quo with provisions designed specifically to address pivotal; **and/or**
 - (v) Introduce measures to improve risk management tools for participants without which a party may resort to its pivotal position to cover a downside exposure (as the Authority observed in the Meridian case).
- This choice of tools should be guided by specialist legal drafting expertise.

Evaluation criteria

Each specific option should then be compared against criteria, including:

- Degree of legal certainty (low uncertainty in legal interpretation)
- Effectiveness in 'trapping' unwanted behaviour (legal delineation and identification of abuse)
- Low chance of unintended consequences
- Readily able to be updated or refined
- Likely to cover other currently unknown unwanted behaviours
- Support of other relevant electricity markets e.g. hedge, FTR
- Integration with other relevant regulations (within the Code/ Commerce Act, FMA)

Other matters

WAG raised but did not develop the idea of:

- Temporary cap
- Obligation on Transpower re outage planning
- Make SO responsible for additional costs.

Other matters *(cont'd)*

Another approach is a blacklist or whitelist

A blacklist is included in the UTS provisions (below)

A black/white list approach could also be considered for unwanted behaviours outlined earlier (such as exercise of market power, market manipulation, insider trading and so on).

However, its legal scope and effect are not clear relative to more detailed provisions targeting the complex unwanted behaviours outlined earlier (such as exercise of market power, market manipulation, insider trading and so on). It seems unlikely that simplistic (almost one line) prohibitions could effectively cover such wide and complex behaviours.

5.1 Occurrence of undesirable trading situation

- (1) If the **Authority** suspects or anticipates the development, or possible development, of an **undesirable trading situation**, the **Authority** may investigate the matter.
- (2) The following are examples of what the **Authority** may consider to constitute an **undesirable trading situation**:
 - (a) manipulative or attempted manipulative trading activity;
 - (b) conduct in relation to trading that is misleading or deceptive, or is likely to mislead or deceive;
 - (c) unwarranted speculation or an undesirable practice;
 - (d) material breach of any law;
 - (e) a situation that threatens orderly trading or proper settlement;
 - (f) any exceptional or unforeseen circumstance that is contrary to the public interest.
- (3) To avoid doubt,—
 - (a) the list of examples in subclause (2) is not an exhaustive list, and does not prevent the **Authority** from finding that an **undesirable trading situation** is developing or has developed in other circumstances; and
 - (b) an example listed in subclause (2) does not constitute an **undesirable trading situation** unless the example comes within the definition of that term in Part 1.

Appendix A: Pivotal explained

Definition of 'pivotal'

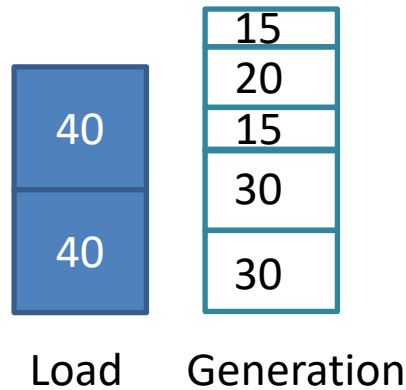
Part 1 of the Code:

pivotal means—

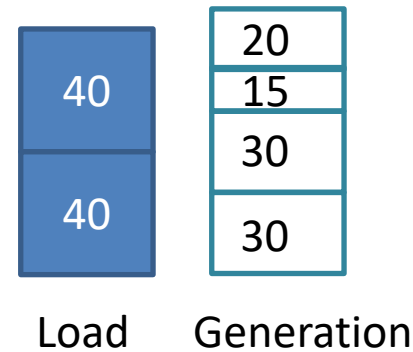
- (a) in relation to a **generator**, that the total **demand** in a **trading period** at any 1 or more **nodes** would not have been met if the **generator** had not submitted **offers** for all or any of its **generating plant**; and
- (b) in relation to an **ancillary service agent**, that the total **demand** in a **trading period** for an **ancillary service** supplied by the **ancillary service agent** in an **island** would not have been met if the **ancillary service agent** had not submitted **reserve offers** for all or any of its capacity to provide **instantaneous reserve** in the **island**

Illustration of 'pivotal'

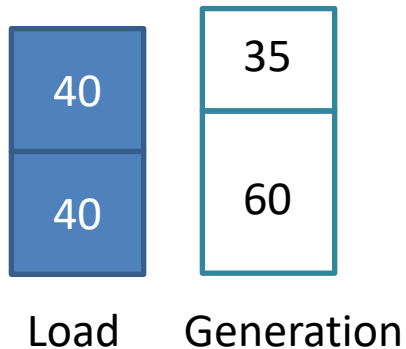
No generator is pivotal



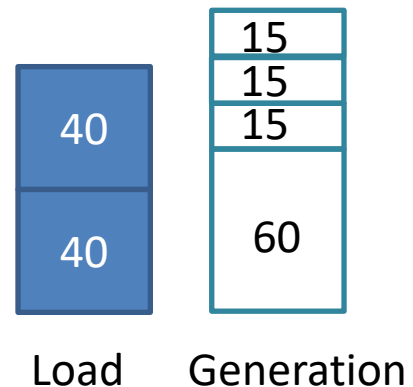
30, 30, 20 MW all pivotal



Both generators are pivotal



Only 60MW pivotal



Definition of 'net pivotal'

From WAG discussion paper:

“A net pivotal supplier is a party that is required to generate to avoid unserved load and whose generation is greater than its own retail and hedge sales in the relevant area”

- Reflected by clause 13.5B(1)(c)(iii) and 13.5B(3)(c)(iii) in safe harbours:

13.5B(1)(c)(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

13.5B(3)(c)(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

A net pivotal supplier has incentives to raise prices

When a supplier is net pivotal they have incentives to raise prices because:

- their hedge position, including retail, provides no financial constraint
- they lack competitive pressure, ie they have market power

Accordingly, the trading conduct safe harbour provisions consider whether a generator or ancillary service agent is net pivotal:

13.5B(1)(c)(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

13.5B(3)(c)(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

A fully hedged pivotal supplier may still have incentives to raise prices

A supplier that is pivotal but not net pivotal, ie with generation $\approx$ hedges/retail, may still have incentives to raise prices in the short term:

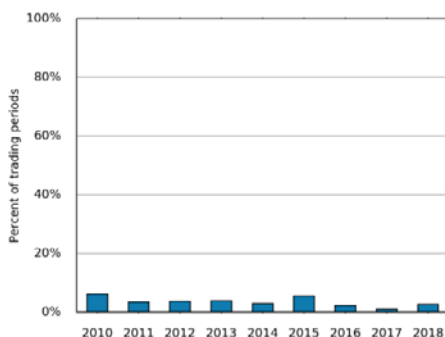
- it may allow the supplier to supply hedges at a higher premium in the future
- it may undermine more exposed competitors and potentially force them to leave the market

Accordingly, a party could potentially be in the safe harbour because they do not “benefit financially” from high prices in the short term, even though they might in the long term

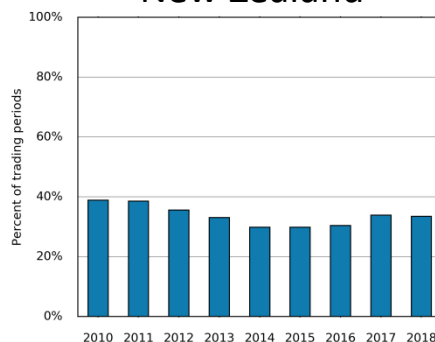
Generators are often pivotal

- Modelled by setting prices to \$30k for plant in region shown (eg Contact, South Island means setting Contact's SI plant to \$30k)
- Graphs show percentage of time the supplier's generation in that region (ie North Island, South Island, across New Zealand) is required to meet national demand
- Note the Code considers whether a party is pivotal on a nodal basis

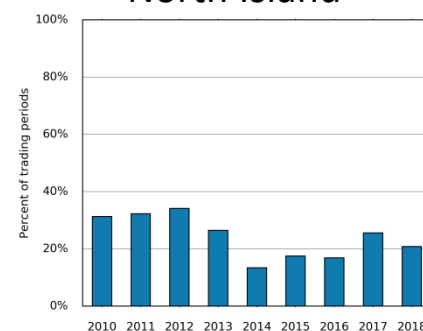
Contact,
South Island



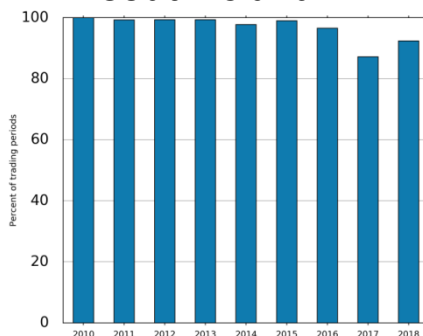
Contact,
New Zealand



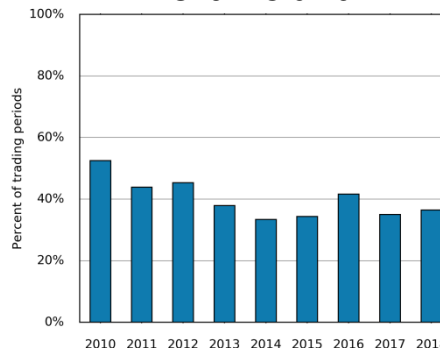
Contact,
North Island



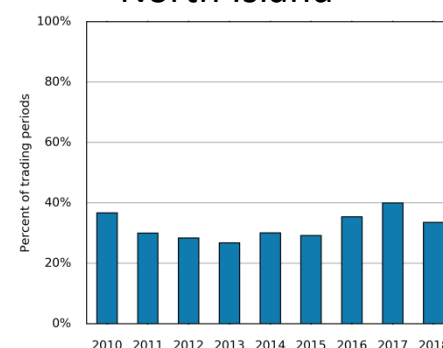
Meridian,
South Island



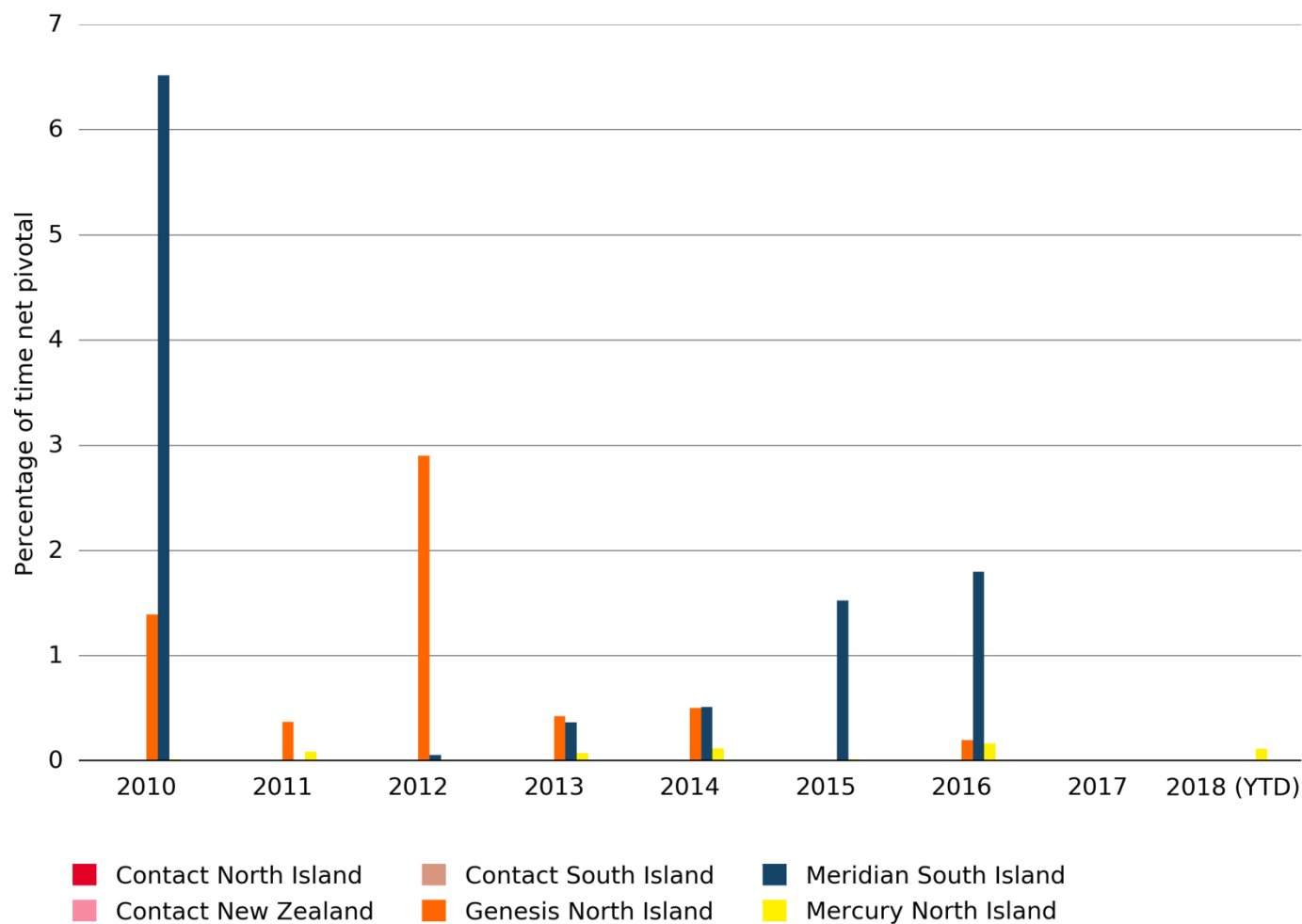
Genesis,
North Island



Mercury,
North Island



Generators are net pivotal less frequently



Source: Electricity Authority

Appendix B:

Current trading conduct 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).
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Trading conduct provisions

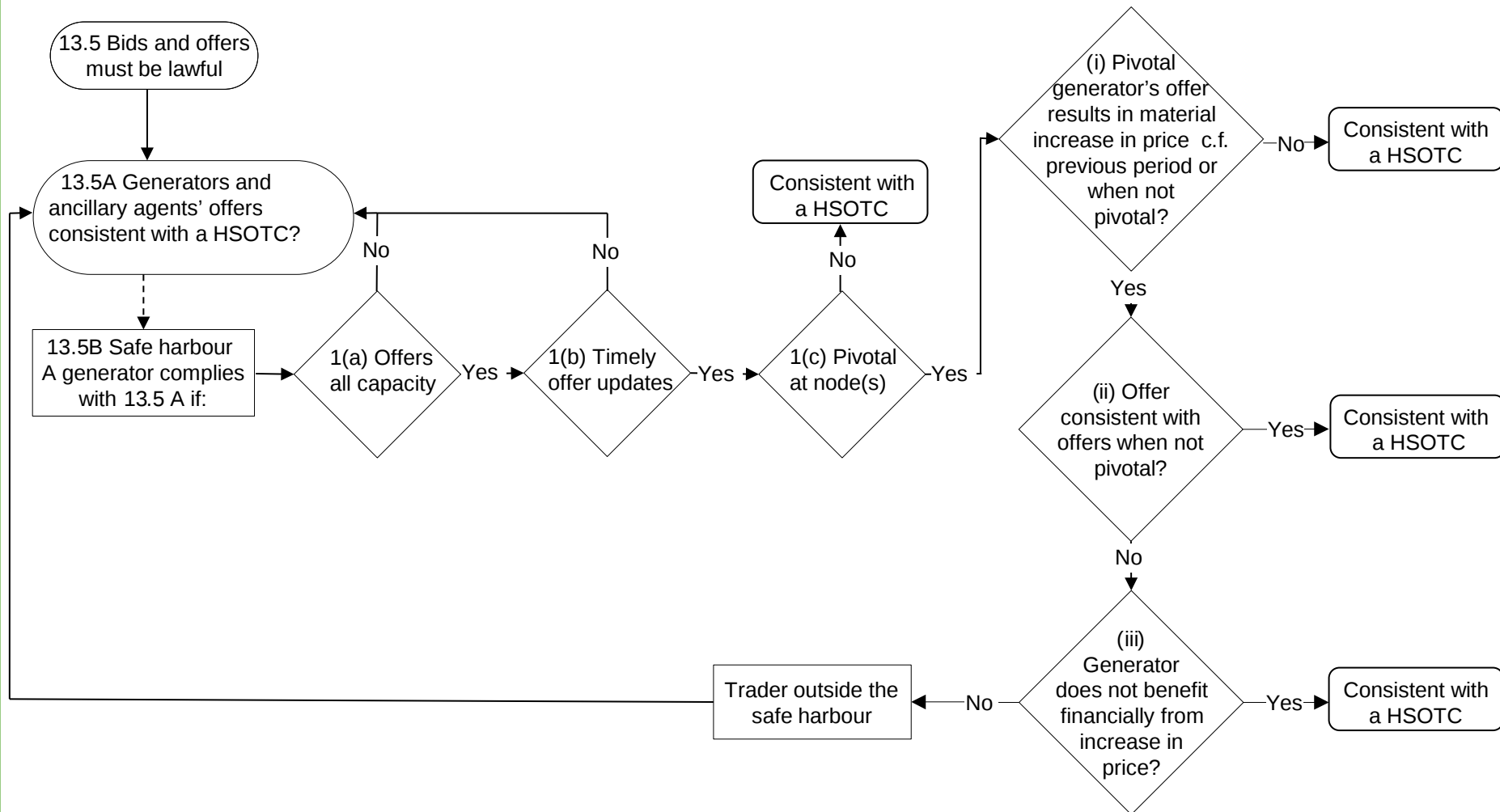
Trading conduct provisions continued:

13.5B Safe harbours for clause 13.5A

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. .
.

- (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).

Overview of trading conduct provisions



Appendix C:
Issues identified in term sheet
not yet considered

4. Code allows revisions to offers but with restrictions

- Clause 13.17(1) permits revisions of offers prior to gate closure
- Clauses 13.17(3) and (4) permit revisions of MW in an offer during gate closure in limited circumstances – basically when a plant's physical capability is different to the original offer

The WAG's suggestion for determining if a pivotal supplier's high prices were efficient

The WAG noted: "Inefficiency will only arise if spot prices in an area subject to pivotal supply diverge from the marginal value of electricity or reserve at that time and location – ie the value that would be established in a workably competitive market" WAG *Discussion paper: Pricing in Pivotal situations*, p.6

Further: "One approach [to determining whether high prices in a pivotal supplier situation are efficient] is to consider a scenario where the pivotal supplier was notionally a number of separate competing entities. If the spot price outcomes observed in practice were broadly similar to those expected under this scenario, there are unlikely to be particular efficiency concerns." WAG *Discussion paper*, p.7.