

REVIEW OF SPOT MARKET TRADING CONDUCT PROVISIONS TERM SHEET

This term sheet captures what the MDAG has agreed so far on the *Review of spot market trading conduct provisions* project following meeting number 14 on Wednesday, 19 June 2019.

Project component	Agreed (or yet to be agreed) terms
Target	Recommendations taking into account Authority's statutory objective, consensus where possible.
2018/19 Work programme target	MDAG publish discussion paper, if any
2019/20 Work programme target	Board response to MDAG advice (focussed on conduct when pivotal)
Scope	The review should consider the following matters, which would form the project scope: a) trading conduct affecting outcomes in the energy and instantaneous reserves markets in the New Zealand wholesale electricity market (spot market) b) 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 c) options, including guidelines, to aid in the interpretation of 'high standard of trading conduct' in clause 13.5A of the Code d) in light of any proposals to assist with interpreting 'high standard of trading conduct', whether the safe harbour provisions should be modified to ensure that behaviour of parties operating within the safe harbour provisions is consistent with a high standard of trading conduct e) 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,

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	or whether it would be preferable to address this by other means, such as amending other Code provisions f) 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. Should MDAG identify matters it considers are best addressed by amending other Code provisions, one option would be for these matters to be addressed through subsequent MDAG projects.
Problem definition	• The general requirement for a 'high standard of trading conduct' (HSTC) is considered unclear. There has been limited development of case law to support understanding of the provision • The "universals" (core) of HSTC-type provisions are generally market manipulation and information asymmetry • An HSTC may be too amorphous to effectively prohibit abuses in these categories. More targeted provisions are used in analogous markets • The trading conduct provisions were originally intended to focus on preventing abuse of pivotal positions but this was subsequently expanded to other unspecified unwanted behaviours • Prohibition on abusing pivotal situations is not necessarily within HSTC, but may be inferred by "safe harbour" provisions • The safe harbours are not available to some plant • The safe harbours may shelter and facilitate behaviour inconsistent with a high standard of trading conduct • The safe harbours may be difficult to apply in practice • The trading conduct provisions only apply to parties making offers • The trading conduct provisions do not prevent withdrawal of plant after gate closure by plant not required to make offers • The safe harbour allows withdrawal of plant or instantaneous reserve for reasons other than bona fide reasons

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	- o The safe harbour requires offers for plant <i>able</i> to operate • 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 • The trading conduct provisions do not specifically address collusion of offers between generators or ancillary service agents – the Commerce Act and the clause 13.5 requirement for offers to be lawful may mean this is unnecessary • The trading conduct provisions do not make clear that offers should reflect the physical underlying capability of the plant - o E.g. ramp rates should reflect the physical capability of the plant and any other restrictions on the plant such as regulation • The trading conduct provisions do not make clear that the physical basis for offers should be consistent across time • The trading conduct provisions do not make clear that offers by plant with a pivotal position should be consistent with offers under workable competition • The trading conduct provisions do not provide guidance when re-offering is appropriate
Options	• There may be some value in describing a set of criteria/principles that bridge the gap between the high level statutory objective and Code requirement for a high standard of trading conduct and the request from some parties for more clarity • Introducing a test for whether behaviour is consistent with a workably competitive market • Outcomes consistent with workable competition include: - o efficient prices – prices reflect opportunity cost of the lowest cost source of supply to meet the next unit of demand - o barriers to entry and exit not limiting or reducing competition - o a variety of tools and the ability to apply different strategies that enable market participants to manage market risk risks • Deleting the safe harbour provisions • The requirement for a high standard of trading conduct should not be limited to the spot market but should also apply to other

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	markets, including the hedge market and FTR market • Introducing guidelines would be beneficial • Findings of reviews and investigations should be published • Eight categories of behaviour we could target have been identified: 1. local abuse of pivotal 2. island abuse of pivotal 3. national abuse of pivotal 4. other abuses of market power 5. insider trading (information asymmetry) 6. market manipulation 7. other (known) types: e.g. predatory pricing, collusion, price fixing 8. other (unknown) types: will evolve in dynamic market • Options for addressing categories of behaviour could include: a) specific provision per behaviour b) tailored provisions for broader category of behaviours c) broad provision for all behaviours d) combo of (a) and (c) • Each specific option should be compared against criteria, including: - o degree of legal certainty (low uncertainty in legal interpretation) - o effectiveness in capturing unwanted behaviour (legal delineation and identification of abuse) - o low chance of unintended consequences - o readily able to be updated or refined - o likely to cover other currently unknown unwanted behaviours - o support of other relevant electricity markets, eg hedge, FTR - o integration with other relevant regulations (within Code / Commerce Act, FMA) •

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Value at stake	
Decisions	Behaviour not consistent with a high standard of trading conduct includes: • having plant available, but not on outage and not offered into the spot market • the use of engineering factors (eg, ramp rates) to affect offers that did not reflect the underlying physical capability of the plant. In addition, the Group has agreed that customers that are hedged are indifferent to the spot outcome in the short term, but still receive a signal from spot market outcomes in the longer term. Analysis has not been able to identify structural changes to behaviour following Meridian and Mercury decisions baring a few minor exceptions. A stakeholder briefing will be held on 30 July 2019 in Auckland, informed by a published discussion pack. An initial discussion paper will be released (targeting September) focussing on conduct when pivotal. The behavioural issue of next highest priority is market manipulation or insider trading. The Sapere paper presenting an option for an effective safe harbour clause has a broad scope, encompassing many behavioural types, rather than just pivotal, which is the current focus of the group.
Issues still to be determined	• For each issue, what are the policy and operational elements that define the boundary between acceptable and unacceptable behaviour? • Whether trading conduct provisions should be broad and rely on case law to establish the boundaries or whether they should be more tightly specified with the provisions themselves establishing the boundaries. - o What is the right legal tool to tackle each issue? • What behaviour change has occurred since the Authority's enforcement action relating to 2 June 2016? How are the South Island generators behaving?