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An "undesirable trading situation"

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looks at the powers of the Electricity Authority

For the first time since government regulation of the electricity market began, the regulator has intervened in the wholesale market for electricity, declared the existence of an 'Undesirable Trading Situation' and adjusted down final trading prices. In *Re Bay of Plenty Energy Ltd* [2012] NZHC 238 (BC201260350), the High Court rejected appeals against that decision. The Court found that the Electricity Authority had not committed any errors of law and upheld the reset prices.

The case follows on from the events of "Big Saturday". On 26 March 2011, following planned maintenance work to the national transmission grid, Genesis Power Ltd found itself to be "net-pivotal" ie, it cornered the market for electricity generation in and north of Hamilton. A generator will be "net pivotal" when it can generate electricity to cover existing supply commitments, and is also able and required to supply additional demand in the market. Because demand could only be fully met by supply from Genesis during the outage, Genesis set the price of electricity on the spot market for that period (for a full explanation see [35–61]). Genesis operates the largest power generator in the country, Huntly, based 70km from Auckland, and there was never any suggestion that supply could not meet demand for the period of the transmission outage. Nevertheless, the State-owned Enterprise offered spot prices to the wholesale market in excess of $20,000 per MWh for a trading period of seven hours. Trades close out on average at between $50 and $150 per MWh. At the inflated price, it was estimated that Genesis would take in the region of $45–50 million. Following "Big Saturday", thirty-five companies, including other generators, retailers and direct consumers of electricity complained to the Electricity Authority.

REGULATORY POWERS

The Electricity Authority is empowered to investigate and enforce compliance with the Electricity Industry Participation Code 2010: the Code that regulates the actions of all industry participants. Specifically, the Authority is empowered to investigate allegations that an 'Undesirable Trading Situation' ("UTS") has occurred. If the Authority finds that an UTS has developed, it has wide discretionary powers to rectify the situation, including deferring completion of trades for a specified period and directing that any trades be closed out or settled at a price specified by the Authority (Electricity Industry Participation Code 2010 cl 5.2(2)(b), (c)).

An UTS is defined in cl 1.1 of the Code as:

> any contingency or event—
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> (a) that threatens, or may threaten, trading on the wholesale market for electricity and that would, or would be likely to, preclude the maintenance of orderly trading or proper settlement of trades; and
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> (b) that, in the reasonable opinion of the Authority, cannot satisfactorily be resolved by any other mechanism available under this Code; and
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> (c) includes, without limitation—
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> (i) manipulative or attempted manipulative trading activity;
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> (ii) conduct in relation to trading that is misleading or deceptive, or is likely to mislead or deceive;
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> (iii) unwarranted speculation or an undesirable practice;
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> (iv) material breach of any law; and
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> (v) any exceptional or unforeseen circumstance that is at variance with, or that threatens or may threaten, generally accepted principles of trading or the public interest.

The Authority interpreted this as requiring paras (a) and (b) to be met for a finding of an UTS, but regarded para (c) as merely providing non-exhaustive examples of situations that might constitute an UTS if (a) and (b) were also met. The High Court accepted this interpretation as correct. To that extent it was not necessary to find, for example, that Genesis had been involved in manipulative trading ((c)(i)) for an UTS declaration to be made. The implications of this are interesting because it confirms that culpability is not an issue. The focus of an UTS is not on penalising poor behaviour but rather on ensuring the smooth-running of the market. This interpretation affords maximum discretion to the Electricity Authority; in determining whether to declare an UTS, the Authority's discretion is not fettered by having to consider, for example, mal-intent on the part of the generator.

"Orderly trading"

The case is complex, the grounds of appeal were many and varied and it is not possible in a brief article to address all the issues. But one critical question in the case turned on the meaning of cl 1.1(a) referring to "orderly trading".

The appellants argued that the proper interpretation of cl 1.1(a) required a focus on technical trades; it "requires the likelihood that ongoing organised trading will stop as a result of the "event" which is said to be the UTS" (at [94]). On the facts, there was no categorical evidence to show that the event had precluded "the proper settlement of trades". But as Ronald Young J observed, this was partly because the issue as to whether trades would be completed at the high price was never tested because intervention took place early (at [280]). In relation to the first part of cl 1.1(a) the Electricity Authority found that the events of 26 March "may" have threatened trading and at least one company averred that it would have been unable to complete trades at the Genesis offer price (Electricity Authority "Final Decision on the Undesirable Trading Situation of 26 March 2011", 4 July 2011, at [52(f)]).

The approach of both the Authority and the High Court however suggested that they interpreted the latter part of cl 1.1(a) as containing alternate, albeit complementary concepts. The Electricity Authority rested its decision on the part of cl 1.1(a) concerned with an event that "would be likely, to preclude the maintenance of orderly trading". The Authority considered that its statutory objective, "to promote competition in, reliable supply by, and the efficient operation of the electricity industry for the long term benefit of consumers" (Electricity Industry Act 2010, s 15) provided an economic context for the interpretative process, a rational for the UTS provisions in the Code and justified the adoption of a wide interpretation of "orderly trading". To this extent, the Authority equated "orderly trading" with the wider concept of "orderly markets"rather than the more discreet focus of "orderly trades". This wider interpretation, once again, increases the discretion available to the Electricity Authority.

A threat to orderly trading?

To determine whether there had been a threat to orderly trading, the Authority considered three consecutive questions. The first was whether Genesis had been in a position to determine prices in a significant portion of the wholesale market during the relevant period. The answer was yes. The second was whether exposed parties had had time to seek supply from other sources or curtail their demand. For various reasons the Authority accepted that such prices were neither foreseen nor foreseeable by "diligent market participants", and purchasers had been unable to avoid taking supply from Genesis. The foreseeability or otherwise of the "event" became a critical part of the argument before the High Court but Ronald Young J declined to find an error of law in the Authority's approach (at [173]–[189].)

The third issue was whether those prices had been likely to undermine the wholesale market to such an extent that an UTS transpired? The Authority answered this in the affirmative and focused, critically, not on the high prices per se but rather on the fact that the prices did not reflect "an underlying supply-demand imbalance" nor did they bear any "resemblance to any underlying or unavoidable cost". The prices did not reflect the proper workings of market forces; on the contrary, they indicated that the market was not working correctly. The Authority found that:

> It is in the public interest to have an electricity market in which all participants can be confident prices are competitively determined. If participants observe that prices are greatly divorced from supply-demand conditions and are excessively higher than underlying costs, they will lose confidence in the integrity of the market arrangements and the incentive structures surrounding the wholesale market for electricity may be greatly damaged.

These were not, therefore, "legitimate" high prices (at [260]). The ramifications of allowing the prices to stand, the Authority found, would be significant: there would be a precedent effect for other generators that found themselves to be net pivotal to abuse their transient market power; as there was no permanent price cap in the market (in comparison to, for example, the Australian market, see [267]) there would be no limit on future spot prices offered; demand-side participants would withdraw from the wholesale market; and "highly inefficient investment signals" would be created and excess additional generation would be installed. This would be the very antithesis to an "orderly market".

The appellants argued that the Authority was misguided in adopting such a broad contextual analysis; rather the focus should have been on the words used in the Code, refers to "orderly trading" not "markets". The High Court rejected the appellants' arguments and deferred to the expertise of the Authority stating "[w]hat is "orderly" in this context the Authority are uniquely qualified to assess" (at [97–99], [219]). That may be correct (see below) and the reforms of electricity regulation following the dissolution of the Electricity Commission, the enactment of the Electricity Industry Act and the creation of the Authority certainly placed even greater emphasis on the market-based expertise of the regulator (compare for example the purpose of the Electricity Commission in ss 172N–0 of the 1992 Act with the objectives of the Authority in ss 15–16 of the 2010 Act) but it is a legal question as to whether cl 1.1(a) is concerned solely with the completion of trades or whether the word "trading" is synonymous with the wider concept of the market, as an entire structure, with a specified purpose.

Wide interpretation justified?

There are a number of reasons to support the Authority's interpretation of cl 1.1(a) as containing both a narrow and a wide focus. This latter interpretation was open to the Authority on the drafting of cl 1.1(a): it is an acceptable approach to the grammatical construction and, if not read as containing two alternative concepts, the clause would be tautological and one or other part rendered otiose. But more importantly, if the clause were interpreted narrowly as "requiring the stopping of trades" then the electricity market regulator would, in contrast to other market regulators, be deprived of a significant weapon in ensuring the timely restoration of orderly markets.

Most market-regulation has a similar purpose: to ensure that markets are fair and orderly. For example, in terms of financial market-regulation, the Financial Markets Authority has the purpose of promoting "fair, orderly and transparent markets" (Securities Market Act 1988, s 36FC(2)(a)); the Financial Services Authority in the United Kingdom is concerned with maintaining public "confidence" in the financial markets (Financial Services and Markets Act 2000 (UK) s 2); and legislation in the United States, regulating the financial markets, is littered with reference to the public interest of ensuring "open, fair and orderly markets" (Securities Exchange Act 1934, s 12(f)(2); Securities Exchange Act 1933; Securities Exchange Act 1934, s 2). The regulation of the electricity market accords with such philosophies.

Financial theory recognises an orderly market as one that provides for the three market efficiencies: operational efficiency, allocative efficiency and pricing efficiency. In other words it ensures that prices are accurately set by the forces of supply and demand (Arnold *Corporate Financial Management* 3rd ed. (2005, Financial Times / Prentice Hall) 401; although note that the concept of "orderly markets" is criticized for indeterminacy by Bradley "Disorderly Conduct: Day Traders and the Ideology of "Fair and Orderly Markets" (2000) 26 Iowa J of Corp L 63.)

To ensure the maintenance of an orderly market, it is not uncommon for regulators to have ex ante mechanisms at their disposal, for example the ability to halt all trading for a period or to suspend certain actors or activities from the market. Halts are often used to ensure the proper dissemination of information so as to promote pricing efficiency, but may, depending on the specific market rules, be used in a more discretionary fashion to pre-empt market disorder.

Seligson v New York Produce Exchange 378 F Supp 1076 (1974) concerned one strand of litigation in a salad oil-swindle. A case was brought against the market regulator for not suspending all trading when a trader managed to acquire over 90 per cent of the futures contracts in the market. The Court stated that "[a] concentration in the long term interest like that achieved by Allied is fraught with potential danger to the market, inasmuch as it reduces liquidity, lessens price stability, heightens the risk of a disorderly liquidation of contracts should the demand curve faced by the party holding the interest shift, and in general threatens the maintenance of an orderly market". The Court accepted a cause of action existed against the Exchange for negligent failure to regulate and found there to be a prima facie case for a timely halt to trading before market disorder ensued.

But the electricity market differs critically from other markets. Electricity cannot be stored (in any economical way) and supply and demand must be in constant balance. Purchasers in the wholesale market cannot refuse to take the electricity offered, even at an inflated price, otherwise there would be "black outs". Aside from the economic damage, "black outs" can pose a risk to human life. The market regulator does not therefore have the power, common in other markets, to halt all trading and suspend the market before the market gets into difficulties. The remedies open to the Authority are, rather, ex post facto. The UTS is an ex post facto mechanism to help restore order to the market. Thus, whilst the Authority cannot call a halt to trading to prevent disorder, it would argue that it should be able to take action as soon as practically possible to restore order to the market. The focus on the need for timely prevention is reinforced by the wording in cl 5.5 of the Code: the Authority must "attempt to correct every undesirable trading situation and, consistently with s 15 of the Act, restore the operation of the wholesale market as soon as possible".

Critics of the Authority's intervention in the present case might pose the question "at what point should the Authority intervene?" or more specifically, "when does a high price become too high and hence illegitimate?" and this is perhaps the crux of the argument as to the interpretation of cl 1.1(a). The appellants would contend that the market itself must answer this question, ie, it is when trades cannot be completed because purchasers are unable or unwilling to pay those high prices. This can be the only true measure of "illegitimacy". But, the Authority would no doubt argue that this approach would be an incentive to disorder. If the court were to accept the interpretation of cl 1.1(a) urged by the appellants, the onus would be placed upon purchasers to create the conditions for an UTS declaration by refusing to complete trades and breaching their contractual obligations. In the event of such default, various actions would be triggered and greater disorder would ensue: the clearing manager would become involved in an investigation under the default provisions of the Code (cl 14.55–14.63), civil litigation may commence, generators may refuse to continue to supply defaulters who in turn could not fulfil their obligations to customers. To limit intervention only to scenarios where trades had or were about to fail would leave one of the most critical and potentially volatile markets without sufficient or timely preventative protection; it may exacerbate disorder and, absent the high-water mark of failed trades, it would not protect the long term health of the market from the more insidious effects of asymmetries. "When do prices become illegitimate?" the Authority would say is a question that it must answer and it is at this point that the specialist expertise of the Authority becomes particularly relevant. Whilst the Authority was cognizant of the general undesirability of ex post facto intervention with markets and the uncertainty this may create, it opined that, "the market would understand the intervention was specific to the circumstances of 26 March" (at [303]). To this extent, the Authority did not believe its decision would act to deter supply-side participants in the market, and the High Court found no error of law in this approach (at [304]).

Following the events of "Big Saturday", the Authority has made several changes to the Code, for example demand side bidding and forecasting has been introduced (Part 13). However, whilst such mechanisms may help to minimise the prospects of similar events re-occurring, they offer no guarantee and the application (or threat) of the UTS provisions will continue to be an important regulatory tool.

THE AUTHORITY'S DISCRETION

In giving the Sixth Sir David Williams lecture to Cambridge University in 2006, Lord Bingham recalled the dangers inherent with broad discretionary powers:

> The broader and more loosely-textured a discretion is, whether conferred on an official or a judge, the greater the scope for subjectivity and hence for arbitrariness, which is the antithesis of the rule of law (Bingham "The Rule of Law" (2007) 66 CLJ 67 at 72.)

The effect of *Re Bay of Plenty Energy* is to confirm, or confer, the maximum discretion for the Authority to determine whether there was an UTS. The Authority can intervene in the electricity market to, in effect, put a ceiling on prices in extraordinary circumstances, but there is no real certainty as to what those circumstances might be.

It perhaps pays to recall the status and general powers of the Authority. The Authority is an independent Crown entity. It is neither democratically elected nor a judicial body. It has the responsibility of administering, drafting and approving amendments to the Code. But the Code, because of the manner of its making (and note that it has its genesis in the multilateral industry contracts that once regulated the industry) does not meet the standards of finished parliamentary draftsmanship. The High Court comments in particular that the "definition of a UTS is not without its difficulties" (at [130]) and this may in part flow from the drafting process. The Authority has the power to make legally binding decisions against industry participants on the basis of the Code but the rules of natural justice do not apply to its decision-making (see for example Electricity Authority "Guidelines for Participants on Undesirable Trading Situation Version 2.1" 1 November 2010, at [18]–[21]). In essence, the Authority regulates an industry that is of critical importance to all New Zealanders and its decisions can have massive financial ramifications as is aptly illustrated in the present case.

There is a sense that although justice appears to have been done on the facts of the case, this was achieved if not by accident, certainly not by regulatory design. The UTS provision is poorly drafted and fails to set out a clear framework for decision-making. This case will be appealed and it is to be hoped that the Court of Appeal gives some guidance as to how the extremely broad, discretionary powers of the Authority to declare an UTS might be clarified, perhaps by recommending that this critical provision be reconsidered and re-drafted with greater clarity. ❐