COMMENTS

POWERCOR AUSTRALIA LIMITED V PACIFIC POWER [1]

THE CASE AND ITS IMPLICATIONS FOR ORGANISATIONS ENGAGED IN ENERGY TRADING

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State-owned New South Wales electricity generator, Pacific Power, has been ordered by Gillard J of the Supreme Court of Victoria to pay $44.7 million in damages to Victorian electricity distributor, Powercor Australia Limited. Pacific Power was also ordered to perform its obligations under 11 commodity derivative contracts ("hedging contracts"). Pacific Power has since lodged an appeal.

The case involved a dispute over whether hedging contracts had been concluded between two parties. The plaintiff—Powercor Australia Ltd - claimed that 11 hedging contracts had been entered into and sought specific performance and damages. The defendant - Pacific Power - denied that the alleged agreements had been concluded and counterclaimed on a number of bases.

THE NEED TO HEDGE AGAINST UNCERTAINTY

The spot price in the national electricity market is the price at which physical delivery of electricity is settled between market participants. Market generators receive the spot price from National Electricity Market Management Company ("NEMMCO") and market customers pay the spot price to NEMMCO.

The volatile nature of the spot price represents market risk to market participants. To provide some long term price certainty, market participants usually enter into financial (non-physical) hedge transactions outside of the national electricity market as a risk management tool.

The *Powercor case* underlines the risks faced by market participants in operating in the national electricity market.

BACKGROUND TO THE DECISION

Prior to commencing their trading relationship, the parties entered into an ISDA Master Agreement (see below) in November 1996. Each hedging transaction entered into between the parties was made under the terms of the ISDA Master Agreement.

Between November 1996 and mid June 1998, the parties entered into 35 hedging contracts which were not disputed. The dispute arose about a further 11 contracts allegedly entered into between November 1997 and June 1998. Some of these contracts priced off-peak power as low as $12.50 a MWh and peak power between $20 and $27 a MWh, well below current spot prices.

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1 [1999] VSC 110 (18 November 1999).

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The dispute turned on the application of a number of contractual principles—formation, intention, estoppel, mistake and authority.

THE DECISION

- **The ISDA Master Agreement and intention to form a contract**

The International Swaps and Derivatives Association ("ISDA") has developed a standard agreement to cover a broad range of transactions. Parties may decide that their commodity transactions will be documented according to the ISDA Master Agreement.

Gillard J rejected the defendant's argument that a contract did not come into existence until a confirmation was signed and exchanged.

First, his Honour construed the terms of the Master Agreement and found that it governed negotiations between the parties leading to a transaction as well as the transaction itself. Under the terms of the Master Agreement, the parties were legally bound in relation to each transaction when they agreed to its terms (whether the agreement was oral or otherwise). The Master Agreement determined when the parties reached a binding agreement and intended to be bound.

Secondly, his Honour considered the prior dealings between the parties. The fact that the parties had commenced performing the contract prior to signing the confirmation in the case of 25 prior transactions also supported the interpretation of the Master Agreement.

Gillard J stated that "the final binding nature of the agreement did not depend upon the exchange of a signed confirmation." The confirmation was held to be merely evidence of the transaction - a record of the pre-existing binding transaction.

Accordingly, although no confirmations were signed or exchanged in respect of the 11 disputed contracts, his Honour held that this did not prevent the parties agreeing to the essential terms of the agreement and forming a binding contract at some time prior to the signing of each confirmation.

- **Had the essential terms been agreed?**

Under the Master Agreement, the parties were legally bound in relation to each transaction when they agreed to its terms. Accordingly, the second issue was whether the essential terms of the 11 alleged hedging contracts had been agreed between the parties.

Gillard J considered that the minimum essential terms for the transactions were:

- identification of the fixed price payer;
- identity of the floating price payer;
- the determination of the floating price;
- the fixed price to be paid for a particular period which is expressed to be peak/off peak;
- the term of the contract;

- the period when the spot price was to be determined; and
- the settlement date for payment.

His Honour considered the evidence in relation to each transaction to determine whether the parties had reached a binding agreement on each of these essential terms.

Because records of what occurred in negotiations between the parties were sometimes inadequate, the credibility of evidence of the trading managers of each party became decisive. The evidence given by the plaintiff's trading manager was considered more persuasive than the defendant's trading manager because he had a well-organised system of record-keeping and detailed notes of discussions. The importance of accurate and systematic records is discussed further later in this article.

- **Estoppel**

The defendant's argument based on estoppel by convention failed. The defendant submitted that the parties had assumed that a contract was not concluded and binding until the confirmation document was signed and exchanged.

Gillard J held that this assumption was contrary to the terms of the Master Agreement. Further, the evidence disclosed that the pattern in respect of the majority of the other undisputed contracts was that the contracts commenced before the signed confirmation was exchanged.

- **Mistake**

His Honour also rejected the defendant's claim that the parties entered into the transactions under a common mistake - minimum load peak factor of 38% was in dispute. The plaintiff demonstrated that it was not mistaken as to any of the terms of the contract.

The defendant also failed to prove it was labouring under any unilateral mistake — its trading manager demonstrated a lack of care in his conduct and was not mistaken as to the load factor term in the Draw Down Product; he simply did not turn his mind to the matter.

- **Trade practices claims**

Gillard J also dismissed the defendant's claim that the plaintiff made misleading and deceptive representations contrary to ss 52 and 53(g) of the *Trade Practices Act 1974* (Cth). Section 52 prohibits a company from engaging in misleading or deceptive conduct. Section 53(g) prohibits a company from making a false or misleading representation concerning the existence, exclusion or effect of any condition, warranty, guarantee, right or remedy.

His Honour said that:

> "this is not the first case in which a defendant faced with a strong case against it trawls over some years of a relationship with the plaintiff and with the benefit of hindsight and a detailed consideration of all the facts comes to the view that what was stated at a particular time was arguably false and misleading and bases a cause of action on it. Often the causes of action are nothing more than the

> desperate attempt by a defendant to make life difficult for a deserving plaintiff. Invariably they lead to energy, time and money being expended on a forlorn cause... this case is another example.[2]

- **Authority**

His Honour found that the defendant's trading manager had actual and ostensible authority to enter into derivative contracts which were binding on the defendant. At all times, the person in the role of trading manager held a senior responsible position at the defendant's organisation. He made all decisions in relation to the transactions which he was negotiating without needing approval from superiors. The defendant acquiesced in his actions of making and accepting offers and negotiating terms.

The plaintiff's trading manager also had the necessary authority to enter into the derivative contracts, and in the event that he did not have such authority, the plaintiff ratified any lack of authority.

TRADING RISK MANAGEMENT

The defendant's inadequate contract management system

This outcome of this case underlines the need for companies engaging in energy trading to have efficient and transparent record keeping systems. Gillard J noted that the need for certainty in a transaction concerning a hedging contract is obvious. The spot prices of electricity is fixed every half hour, is subject to change and, on occasions, can rise and fall by substantial sums. It is therefore of the utmost importance to those negotiating each transaction to know precisely the time when each transaction is made.

In the *Powercor case*, his Honour heard how the trading managers who negotiated contracts on behalf of the defendant and plaintiff used a lot of jargon and their own terminology when negotiating the essential terms of a hedging contract.

Central to the case were the recollections, records and credibility of the two trading managers involved. The plaintiff's trading manager took notes of most conversations and meetings, had them typed up, and on some occasions forwarded agendas and minutes of meetings to the defendant's trading manager. He sent out correspondence setting out discussions on what was agreed and his company had in place an excellent system of recording deals and transactions. His Honour commented that the plaintiff's trading manager was efficient and well organised and, in giving evidence, he was able to look at the contemporaneous documents prepared by him, such as file notes.

In contrast, the defendant company was found to have had an *ad hoc* system of keeping records. It had no summaries of offers made or terms agreed. Negotiations and discussions were left to the memory of traders and incomplete notes and correspondence in files. There were no summaries of negotiations. The defendant's trading manager had made very few notes of meetings and discussions and was found to have rarely typed up minutes or exchanged them.

The plaintiff's manager's due diligence served him well and Gillard J found him to be the more credible witness "because of his note taking, efficiency and better memory". His Honour generally preferred his

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2 Ibid 170.

version of events because he had "more confidence in his recall, general efficiency and attention to detail".

In addition, a Telephone Dealing Supplement had been executed by the parties which provided for the recording of telephone calls. In March 1998, the plaintiff, without informing the defendant, established a recording system whereby each telephone call to and from the plaintiff was recorded. These recordings were also used in evidence to help determine whether the essential terms and conditions of each transaction had been agreed.

This case highlights the importance of creating and implementing a trading risk management program and periodically reviewing the efficacy of such systems against good trading risk management policy and Australian Standards. Australian Standard AS 3806/1999, *Compliance Programs*, and AS/NZS 4360/1999, *Risk Management* provide a generic guide to the establishment and implementation of an effective compliance system and risk management program. We discuss below some of the important aspects of a risk management program in the context of trading.

Trading risk management programs

Organisations engaged in electricity trading should evaluate their current trading risk management practices to identify and analyse potential legal, credit and performance risks. Safeguards to reduce the probability of poorly managed outcomes could then be designed and implemented.

In particular, transactions in over-the-counter futures markets require a rigorous assessment of the counterparty credit and performance risk because these transactions are not supported clearing arrangements and therefore contract performance is not underwritten by a clearing house and its members.

Counterparty credit risk can be mitigated by the parties entering into an ISDA Master Agreement which gives the parties benefits such as netting and the ability to specify market disruption events.

Also, performance risk is a very important aspect because, if a counter-party is unable to perform its obligations, then the other party will be exposed to buying or selling at market price without any hedging protection in place.

In broad general terms, a trading risk management program will have three components: a scope and purpose, essential elements and ongoing management.

Scope and purpose

The scope and purpose of the trading risk management program must be clearly identified and agreed upon by an organisation before it is developed. The implementation of aspects of a program will differ between organisations. Issues such as commitment, control and compliance policy and management responsibility apply regardless of the size of the company.

The program has to be regarded by the organisation as an important element in its corporate governance and should:

- aim to prevent, and respond to, breaches of law, regulations, codes or organisational standards within the organisation;

- promote a culture of compliance within the organisation; and
- assist the organisation in remaining (or becoming) a good corporate citizen.

Essential elements

An effective trading risk management program will ordinarily contain two elements: structural elements and operational elements.

In terms of structural elements, a key requirement is that of commitment: a clear commitment towards effective compliance is required by all levels of people in an organisation. Appropriate checks and balances must be in place to control and encourage compliance.

For example, clear lines of authority are a critical structural element of a trading risk management program. This requires giving trading staff a clear authority to communicate offers and acceptances. Also, an organisation needs to develop additional authorisation procedures where the dollar value of the contracts reaches a certain threshold, such as obtaining the authority of two or more senior managers (if this is not done anyway). In some cases, advance sign-off from the board of directors should be required before an offer can be made or accepted.

Further, the lines of authority should be documented and circulated throughout the organisation. Also, it is important for both parties to a hedging transaction to insist on having a current trading mandate which lists authorised trading staff and authorised signatories who can sign trading confirmations.

From an operational perspective, there needs to be systematic identification and management of compliance issues created by the organisation's trading operations. This may be best achieved by a separation of duty in the trading section. Ideally, a trading section could have the following divisions:

- trading division (which negotiates each transaction and assesses the market risk);
- credit division (to evaluate all risk aspects of the trading deal and provide supporting reports); and
- administration division (to manage all the administrative aspects of each trading transaction (from input into the system to final payments on the deals).

A separation of responsibility between the trading and credit divisions in an organisation ensures that each transaction is reviewed independently from the trader which negotiated the deal. The credit division is also in a better position to effectively monitor the organisation's aggregate trading risk limit, assisted by data input from administration.

The organisation also needs to implement systems to ensure that timely advice of changes to applicable laws and regulations, such as the *National Electricity Code*, and the ISDA Master Agreement and related documentation are received, distributed and well understood by trading staff. Such advice can be obtained through a combination of arrangements with legal advisors or relevant regulators, attending industry forums or seminars, or subscribing to relevant information services and involve regular reviews of operational arrangements or organisational goals. Internal and external training programs may be required.

Monitoring and assessment

A monitoring strategy should be established which sets out internal and external monitoring processes, and which outlines the schedule for the program, the resources required and the data to be collected.

The program should be assessed against predetermined documented objectives and assessment criteria which cover staff training, activities on risk avoidance, quality control and assessment of the program and details of alleged contraventions of the law and of organisational standards which have been identified and the extent to which similar conduct may have subsequently occurred.

The effectiveness and appropriateness of the trading risk management program must be reviewed at specified intervals. The frequency of reviews will probably depend on the nature of trading operations and policies of the organisation. Review is necessary to identify and understand reasons for non-compliance and to identify and design such measures that are capable of improving the ability of the organisation to manage risk.

The review could be organised by an appropriately experienced manager or other persons within the company, by an independent review or consultant.

Compliance with *Corporations (Exempt Futures Market - National Wholesale Electricity) Declaration* 1999 - MO 85

Section 1123 of the *Corporations Law* prohibits a person from establishing or conducting an "unauthorised futures market". Under section 1127 of the *Corporations Law*, the Minister has made a national exempt market declaration for electricity. Accordingly, many electricity market participants have registered with ASIC as a "registered facility provider" to enjoy the benefits of the *Corporations (Exempt Futures Market - National Wholesale Electricity) Declaration* 1999.

The declaration contains a number of conditions with which registered facility providers will need to comply. These conditions should already be incorporated into the trading risk management program of an organisation as a matter of good risk management. For example, s 10 of the *Declaration* requires a registered facility provider to be "satisfied on reasonable grounds about the credit worthiness of the counterparty and the capacity in which the counterparty is contracting."

The *Declaration* also imposes requirements about establishing management processes and monitoring systems to monitor a registered facility provider's financial capacity to meet the hedging contracts and generally monitor, manage and control its hedging activities. Facility providers must also report on its managements processes and monitoring systems to ASIC and maintain records for each futures contract for five years after the completion of the contract.

Importantly in the context of the *Powercor case*, registered facility providers must also monitor their own creditworthiness and capacity to meet obligation under futures contracts before entering into each transaction.