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123 Paragraphs

ENRON AUSTRALIA FINANCE PTY LTD (in liq) v INTEGRAL ENERGY AUSTRALIA - BC200205233

SUPREME COURT OF NEW SOUTH WALES EQUITY DIVISION COMMERCIAL LIST
EINSTEIN J

50042/02

19-23 August 2002, 3 September 2002

Enron Australia Finance Pty Ltd (in liq) v Integral Energy Australia [**2002] NSWSC 753**

Contract -- Construction -- Principles applicable to construction of commercial contracts -- Necessity for attention to the language used by the parties, the commercial circumstances which the document addresses and the objects which it is intended to secure -- ISDA Master Agreement as varied for application to a series of electricity swap agreements in Australian context -- Early termination mechanism -- Meaning and operation of "Market Quotation" as defined -- Whether experts/Reference Market-makers carried out their task in accordance with the terms of the contract -- Natural justice -- Procedural fairness -- Whether rules of natural justice applicable to appointment of experts/Reference Market-makers

Acts cited:

Arbitration Act 1973 (Queensland)
Energy Service Corporations Act 1995 (NSW)
Evidence Act 1995 (NSW)

Einstein J

[1] These proceedings concern the proper construction of a particular clause in an agreement known as the ISDA Master Agreement ["the ISDA Master" or "the umbrella agreement"] which is part of a suite of agreements brought into existence by the International Swaps and Derivatives Association, Inc., formerly known as the International Swap Dealers Association, Inc. The version used in Australia ["the ISDA (Australia)"] in dealings between the parties included some variations to be found in a schedule.

[2] The contract is contained in the following documents.

o ISDA Master Agreement dated as of 10 September 1999;
o Schedule to the Master Agreement (Multi-Currency - Cross Border) dated as of 10 September 1999 ("Schedule");
o March 1994 Australian Addendum No 11 - Commodity Transactions;

o June 1997 Australian Addendum No 13 - Electricity Transactions.

[3] The plaintiff, Enron Australia Finance Pty Ltd (in liq) ["Enron"] was together with a number of other companies, a subsidiary of Enron Corp which, until it was placed into liquidation on 2 December 2001, was the largest power trading company in the world. On that date it filed in the United States for Chapter 11 bankruptcy and ceased trading. On the following day 3 December 2001 ["the date of administration"], Mr Singleton and Mr Sims of Sims Lockwood in Sydney were appointed administrators of Enron. On 29 January 2002 Enron was placed into liquidation and the administrators then became liquidators of Enron.

[4] Between December 1998 and December 2001 Enron had traded, amongst other things, electricity derivatives or electricity swap contracts in relation to electricity to be supplied in the National Electricity Market. The company was one of the largest and most active traders in the electricity derivatives market in Australia and during the year December 2000 up to December 2001 it entered into electricity swap contracts comprising approximately 17 percent of the market.

[5] The defendant, Integral Energy Australia ["Integral"] is a statutory state owned corporation constituted under the Energy Service Corporations Act 1995 (NSW).

[6] The proceedings concern a series of electricity swap contracts entered into between Enron and Integral under the ISDA (Australia). The particular dispute arises in circumstances where in reliance upon the appointment of the administrators as an Event of Default within the meaning of cl5(a)(viii)(2) and cl5(a)(viii)(4), Integral designated 5 December 2001 as the Early Termination Date for all outstanding electricity swap contracts ("outstanding transactions") under the agreement. The dispute concerns the operation of the provisions governing the occurrence under the ISDA (Australia) of an Event of Default in terms of the determination of the amount, if any, payable by Enron to Integral under cl6(e) of the agreement

[7] The central question is whether certain 'experts' who, under the Agreement, purported to value the rights of the respective parties of the terminated swaps, acted within the terms of the Agreement. [In this early part of the judgment the word 'value' is used in a neutral sense as a vital issue concerns

(i) the proper construction of the provision as to whether the experts were required to 'value' or to 'quote' and
(ii) regardless of the proper construction, what they:

o stated that they had done in carrying out their task;
o had in fact done in carrying out their task.]

[8] The definition in cl14 was as follows:

""Market Quotation" means, with respect to ... [the non-defaulting Party, in this case Integral], an amount determined on the basis of quotations from Reference Market-makers. Each quotation will be for an amount, if any, that would be paid to [Integral] (expressed as a negative number) or by [Integral] (expressed as a positive number) in consideration of an agreement between ... [Integral] and the quoting Reference Market-maker to enter into a transaction (the "Replacement transaction") that would have the effect of preserving for [Integral] the economic equivalent of any payment ... by [Integral and the quoting Reference Market-maker] under [the Confirmation evidencing such Replacement transaction] .... If more than three quotations are provided, the Market Quotation will be the arithmetic mean of the quotations, without regard to the quotations having the highest and lowest values. If exactly three such quotations are provided, the Market Quotation will be the quotation remaining after disregarding the highest and lowest quotations .... "

How a Swap Contract works

[9] The subject swap contracts are for the purchase and sale, *notionally*, of electricity. The market in Australia for such

swaps is what is commonly described as an Over The Counter [or 'OTC'] market, meaning that there is no central exchange such as the ASX, but that contracts are negotiated on an individual basis between counter parties. The basic operation of the Australian market is explained in the affidavit of Ms Heidi Mason sworn 21 June 2002. Whilst a deal of her evidence requires careful examination as she was not put forward as having s79 Evidence Act specialised knowledge, in the main her evidence could not be said to be genuinely in issue and simply serves as giving broad adjectival information as to the workings of the market with which she had considerable familiarity and was in a position to give either evidence of fact or to give lay opinion [cf Evidence Act s78]. In most areas her evidence was confirmatory of other evidence before the Court whether in the form of witness evidence or documentary evidence.

[10] One party ("the buyer") pays a fixed price; the other ("the seller") pays a floating price (namely, the electricity spot price). The spot price is determined on a half hourly basis in accordance with rules governing the National Electricity Market. The spot price fluctuates and may do so significantly from hour to hour, day to day and year to year.

[11] At settlement date the two are netted off.

[12] If on settlement date the spot price is more than the fixed price, then the seller pays the buyer the difference. If on the settlement date the spot price is less than the fixed price, then the buyer pays the seller the difference.

Early Termination

[13] If there is an early termination, there is a contractual mechanism for determining the then economic value of the outstanding swap contracts (negative or positive as the case may be) and for a payment to be made accordingly. The mechanism is to derive a "Settlement Amount" (cl6(e)(i)(3)). If the "Settlement Amount" is positive, it is an amount payable by the defaulting party to the non-defaulting party. If it is negative, then it is payable by the non-defaulting party to the defaulting party.

[14] The counter intuitive aspect concerns the circumstance that whereas a fixed price buyer who was, for example, negotiating to enter into a swap contract, would clearly be advantaged by the lowest *then* spot price, when looking at the situation of such fixed price buyer following an early termination by the fixed price seller, the former is now advantaged by the highest possible prevailing spot price. This is because the mechanism operates to require the defaulting party, in this case the fixed price seller, to pay to the non defaulting party, the difference between the fixed price which had regulated their swap contract and the spot price as at the Early Termination Date. The precise workings of the mechanism are returned to below.

[15] In respect of outstanding swaps, the "Settlement Amount" is the "Market Quotation" (whether negative or positive) (cl14).

[16] The construction issue concerns what Market-makers are required to do in terms of the contractual mechanism.

[17] Reference Market-makers give quotations. The plaintiff's case is that these are quotations for the amount which they would pay or be paid, as the case may be, to enter into a contract preserving the economic equivalent for the non-defaulting party, described as "such party" (and inferentially and necessarily also for the defaulting party) of the terminated contract.

[18] The defendant's case is that they are quotations being an amount which the person giving a quotation would be prepared to pay or accept for the acquisition or sale, as the case may be, to enter into each particular replacement transaction. It is not a *valuation* nor is it an *assessment of the fair price* for entering into the relevant transaction.

[19] An amount that would be payable *to* the non-defaulting party by the Reference Market-maker is expressed as a negative number. An amount that would be payable *by* the non-defaulting party to the Reference Market-maker is expressed as a positive number.

[20] The consequence is that if the amount determined by the Reference Market-maker is a positive number, then it translates into a positive Settlement Amount, and is therefore an amount the defaulting party pays to the non-defaulting party. Conversely, if it is a negative number, then it translates into a negative Settlement Amount and is therefore an amount the non-defaulting party pays to the defaulting party (cl6(e)(i)(3)).

[21] The plaintiff illustrated how this works as follows in terms of an example swap in which the agreed amount is $30 (the floating amount is determined at a future time):

FIGURE A

(market price has gone up and buyer defaults)	
(defaulting party)	(non-defaulting party)
	fixed amount
	$30.00
buyer	seller
"bid"	"offer" or "ask"
	$35.00
	floating amount (spot price at settlement)

The buyer is paying only $30 and receiving $35. He would thus be prepared now to pay $5 more to get the same contract. Here, therefore, the amount would be paid to "such party", ie the non-defaulting party, and would be expressed as a negative number. A negative number is an amount to be paid by the non-defaulting party to the defaulting party (cl6(e)(i)(3)). This makes sense because the price has moved in favour of the defaulting party. He is paying only $30 to get $35 in return.

FIGURE B

(market price has gone down and buyer defaults)	
(defaulting party)	(non-defaulting party)
	fixed amount
	$30.00
buyer	seller
	$25.00
	floating amount

The buyer is paying $30 and receiving only $25. He would now have to pay less to get the same cover. The seller, ie non-defaulting party, would be prepared to pay in $5. An amount payable *by* "such party" is a positive number and thus is to be paid by the defaulting party to the non-defaulting party. In this case, the market has moved *against* the defaulting party.

FIGURE C

(market price has gone up and seller defaults)	
(non-defaulting party)	(defaulting party)
	fixed amount
	$30.00

buyer	seller
"bid"	"offer" or "ask"
	$35.00
	floating amount
	(spot price at settlement)

The seller is paying $35 and only receiving $30. He would thus now require to be paid $5 more to enter into the same contract. Here, therefore, the amount would be paid *by* "such party", ie the non-defaulting party, and would be expressed as a positive number. A positive number is an amount to be paid by the defaulting party to the non-defaulting party (cl6(e)(i)(3)). This makes sense because the price has moved *against* the defaulting party. He is receiving only $30 and has to pay $35 in return.

FIGURE D

(market price has gone down and seller defaults)	
(non-defaulting party)	(defaulting party)
	fixed amount
	$30.00
buyer	seller
	$25.00
	floating amount

The seller is receiving $30 but paying only $25. He would pay $5 to get this beneficial contract. An amount payable *to* the non-defaulting party (ie "such party") is a negative number and is thus to be paid by the non-defaulting party to the defaulting party. In this case, the market has moved *in favour* of the defaulting party.

[22] The construction issue raised in the proceedings requires some significant adjectival knowledge as to the genesis of the so-called ISDA 'umbrella agreement' because that agreement had been in operation for approximately seven years before the ISDA (Australia) was executed. Hence the matrix of fact legitimate to be taken into account in construing the *umbrella agreement* in this case may, depending upon the evidence, require to include the manner in which, to the knowledge of both parties, the umbrella agreement had been utilised as a working document for some time before the 1999 agreement was entered into. If it be that on the evidence there was to the knowledge of the parties operating in the Australian context, real precision in the manner in which the umbrella agreement had been treated or construed or utilised in the working out of disputes four square with the instant dispute, that matter is capable of being taken into account by the court in construing the subject clause of relevance. The matter is not however foreclosed because the ISDA (Australia) departed from the umbrella agreement in a number of respects, the most significant of which concerns the identity of the Reference Market-makers. The ISDA required the appointment of four leading dealers as Reference Market-makers. The ISDA (Australia) required the appointment of experts as such Reference Market-makers. Additionally and probably explaining why this was so, is the fact that on the evidence the electricity derivative markets in overseas countries where the ISDA is used as the umbrella agreement, is a liquid market whereas at all material times the Australian market was illiquid. As will be seen these are important matters to keep in mind when the proper construction of the ISDA (Australia) falls for determination.

[23] Questions of whether or not, and if so for what particular reason and on what particular basis, expert evidence as to the proper construction of the umbrella agreement was admissible arose for determination. The matter was explained in the course of the interlocutory judgment when examining relevance of certain evidence sought to be put forward in this regard (and the qualifications within s79 of, in particular, the expert put forward by the defendant to express opinions)

as raising the following aspects which fall for consideration:

Whether the term "market quotation" is a technical term or term of art or a term explicable by reference to custom or usage and/or whether for other reasons, the parties are to be permitted to seek to prove that they intended to use the word by reference to a specialised meaning. The matter may arise in a number of ways:

o In the case of custom it is well established that the custom must be notorious, certain, legal and reasonable.

o Where a word has a particular meaning among a particular class of person, evidence is admissible to show that the parties intended to give the word that meaning, so that upon proof of that intention, the word should be construed accordingly.

This principle complements, and to some extent, overlaps with the principle that the court will interpret non-legal technical terms in their technical sense, if it appears from the circumstances that the parties intended the words to be so construed. It is difficult to distinguish, if distinction is needed, between cases in which the court is construing a technical term, and cases where the court is recognising a trade usage.

o Where parties have previously dealt with each other on a regular basis, so that there is a course of dealing, evidence of this may also be used to incorporate terms into the contract or to negative the implication of a term which may otherwise be implied. If the course of dealing has the effect of placing a particular meaning on the terms of a document, the parties may be bound by that course of dealing, arguably even if it involves the admission of subsequent conduct as evidence.

o Where a word has both an ordinary meaning and a specialised meaning, evidence is not admitted of the specialised meaning unless it is proved first, that the parties intended to use the word in the latter sense.

o Where both parties are aware of a secondary meaning and that fact is proved by evidence, the secondary meaning will be given effect, even though it may not amount to a technical term or trade custom. In Scragg v UK Temperance & General Provident Institution [1976] 2 Lloyds Rep 227 a question arose as to whether a sprint event was within the words "motor racing" in an insurance policy. The holding was that as a matter of ordinary English it was, but that both the insured and the insurer had been aware that the words were used in a *special* sense by those interested in motor sports, and admitted evidence as to that special meaning. Many words, however, do not have a recognised "ordinary" or "primary" meaning. In such a case the court selects the meaning to be given to the word from an examination of the context in which it is used and of the facts to which the word is to be applied.

[24] The case also concerns the difficulty which arises where in the absence of any direct evidence that Enron and Integral prior to entering into the ISDA (Australia) were aware of the manner in which the ISDA has generally been treated for the purposes of the closeout/early determination mechanism in those overseas countries where the ISDA was the regulating contractual document. An attempt was made by the defendant to suggest that on the evidence the court ought to hold that such mutual knowledge was indeed held by both parties. But as will appear from what follows, the evidence is by no means of any strength in this regard and the court, notwithstanding what would seemingly be a fairly simple inference to draw, is as always, bound hand and foot by the actual evidence adduced. The matter is one requiring a relevant finding of fact.

[25] Likewise because of the necessity to construe the 1999 agreement it is plainly necessary for the court to take into account the context in which that agreement was entered into. That context requires the court to examine aspects of the market for electricity swap contracts.

ISDA

[26] ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, fixed income, equity, commodity, and credit swaps, caps,

collars, floors, swaptions and other options. ISDA was chartered in 1985 and today includes more than 575 member institutions from 42 countries on six continents. These members include most of the world's major institutions that are dealers in, or are leading end-users of, privately negotiated derivatives, as well as governmental entities, associated service providers, brokers, law firms and consultants.

[27] ISDA devotes significant on-going effort to, among other things, preparing and developing standardized documentation for derivatives transactions. ISDA publishes all of its documentation globally, making it available to ISDA's members but also to all interested parties. ISDA documentation may be purchased, for example, through its Internet Website, at www.ISDA.org.

[28] The 1987 ISDA Interest Rate and Currency Exchange Agreement (the "1987 Agreement"), was ISDA's first *standard form* master agreement. It was published by ISDA in 1987 to assist parties in documenting interest rate and currency exchange transactions. A group known as the ISDA Documentation Task Force had been responsible for drafting and commenting upon the 1987 Agreement.

[29] The 1992 (Multicurrency-Cross Border) ISDA Master Agreement (the "ISDA Master Agreement"), was ISDA's second *standard form* master agreement. It was published by ISDA in 1992 to assist parties in documenting a wide range of privately negotiated derivatives transactions. A group known as the ISDA Documentation Working Group had been responsible for drafting and commenting upon the ISDA Master Agreement.

[30] The ISDA Master Agreement, like the 1987 Agreement before it, establishes internationally accepted standards governing privately negotiated derivatives transactions currently estimated to exceed USD 69.2 trillion in notional amounts outstanding.

[31] The ISDA Master Agreement is an important risk management tool that helps reduce documentation risk, promote legal certainty, and reduce credit risk through netting of contractual obligations. As the business has developed and grown, ISDA has expanded and updated the ISDA Master Agreement and its supporting documents, a process that continues today.

[32] The kinds of transactions that may be documented under the ISDA Master Agreement are transactions ("Transactions") under which either or both of the parties have absolute or contingent payment or delivery obligations to the other. The value of these Transactions is derived from, among other things, reference to a specified price, rate, or commodity. That underlying price, rate, or commodity, along with the other bargained for terms negotiated between the parties and included in the confirmations ("Confirmations") evidencing those Transactions, determines the value of those Transactions.

[33] Generally speaking, the Master Agreement provides that Transactions may be terminated before their specified termination dates upon the occurrence of an "Event of Default" or a "Termination Event" (as those terms are defined in Section 14 of the Master Agreement) and sets forth the procedures for doing so. See Sections 6(a) and 6(b) of the Master Agreement.

The unexceptional facts

[34] Prior to 5 December 2001, Enron and Integral entered into a number of Transactions under the Master Agreement. These Transactions were -fixed/floating electricity swaps.

[35] On 3 December 2001, voluntary administrators were appointed for Enron. This appointment constituted an Event of Default by Enron under Section 5(a)(vii) of the Master Agreement.

[36] In accordance with Section 6(a) of the Master Agreement, Integral notified Enron, by letter dated 5 December 2001, that 5 December 2001 would be the Early Termination Date for all outstanding Transactions under the Master Agreement.

[37] There were 65 Transactions outstanding as of the Early Termination Date (5 December 2001). Each of those Transactions was terminated as of that date. Integral was the floating price payer (seller) in 33 of those Transactions and the fixed price payer (buyer) in 32 of them. In the aggregate, those Transactions represented 565 gross megawatts of capacity.

[38] In accordance with Pt1, para(e) of the Schedule to the Master Agreement, Enron and Integral agreed that for purposes of Section 6(e) of the Master Agreement, which sets forth the procedures to be followed by a party that has designated an Early Termination Date, Market Quotation (and so-called Second Method, which is not relevant to this case) would apply.

[39] The chief executive officer of the Australian Financial Markets Association ("AFMA"), in accordance with Pt5, para(k)(vii) of the Schedule to the Master Agreement, selected four experts for the purpose of determining Market Quotation on behalf of Integral.

[40] The standard (ie, pre-printed) definition of Reference Market-makers in Section 14 of the Master Agreement provides in relevant part as follows:

"*Reference Market-makers*" means four leading dealers in the relevant market selected by the party determining a Market Quotation in good faith ... from among dealers of the highest credit standing which satisfy all the criteria such party applies generally at the time in deciding whether to offer or to make an extension of credit..."

[41] Pt5, para(k)(vii) of the Schedule to the Master Agreement provided as follows:

"The definition of 'Reference Market-makers' is replaced with:

'Reference Market-makers' means four experts having an office in Australia selected in good faith by the chief executive officer for the time being of Australian Financial Markets Association (or any successor body) at the request of one of the parties."

[42] Although Enron and Integral amended the definition of Reference Market-makers in their Master Agreement, they did not amend the definition of Market Quotation.

[43] The four experts chosen were individuals with Macquarie Risk Advisory Services Ltd ("Macquarie"); Accenture Australia Ltd ("Accenture"); Deloitte Touche Tohmatsu ("Deloitte"); and Ernst & Young ("E & Y").

[44] Each expert furnished its quotation to Integral (for the 65 Terminated Transactions as of the Early Termination Date), as follows:

Expert	Quotation
Accenture	A$ 396,844.36
Macquarie	A$ 1,482,797.43
E & Y	A$ 1,685,941.59
Deloitte	A$ 1,807,161.00

[45] The judgment below deals with particular aspects of what the evidence disclosed in relation to the approaches taken by these experts in some detail.

[46] By letter dated 17 January 2002 from Integral to Enron, Integral advised Enron that, after disregarding the highest quotation (from E & Y) and the lowest quotation (from Accenture), the Market Quotation for the 65 terminated Transactions was A$1,584,396.51, which was the average of the two remaining quotations.

Evidentiary ruling-Mr Greene

[47] In relation to the report given by Mr Greene of 30 July 2002 the position which obtained during the hearing was as follows:

o the defendants tendered a version of the report which had been blue pencilled [by "boxing in" the items which were blue pencilled] to delete those sections which were not pressed following the courts Judgment in relation to specialised knowledge.

o this version of the report was admitted into evidence as exhibit D5 subject to the further objections which the plaintiff advanced and which objections were identified by being highlighted in orange on a further copy of the document which became MFI P3. The courts ruling in relation to these plaintiff's objections was reserved.

[48] The court rejects these objections as of no substance so that exhibit D5 represents the report insofar as it was held to have been admissible.

The structure of the judgment

[49] The convenient way forward would appear to be to:

o set out in some detail the evidence given by Ms Mason, a great deal of which was relatively uncontroversial and which serves to sketch in a deal of material information going to the manner in which electricity swaps contracts work and going to the market generally;

o set out in some detail the evidence given by Mr Lonergan, a deal of which was not cross-examined on and which treats with a close analysis of precisely what the Reference Market makers did;

o shortly treat with the evidence given by Mr Greene;

o set out formal findings in relation to the AFMA curve;

o set out formal findings as to the effect of what was done;

o cover some matters of principle in terms of outlining the proper approach to an attempt to impugn a valuation exercise;

o deal with the construction issue;

o deal with the nature of the alleged mistake and whether the experts had not done what they were appointed to do;

o deal with the extent to which the court has jurisdiction to interfere with a valuation exercise;

o deal with whether the court should exercise that jurisdiction in this case and with what result;

o deal with the demurrer issue arising in relation to the plaintiff's claim to further amend the summons.

Evidence given by Ms Mason

[50] Ms Mason gave evidence on behalf of the plaintiff, having been from May 1999 responsible for all of the finance, administration and IT functions of Enron and having performed the same role in seven related Enron companies in Australia. She had trained with Peat Marwick Hungerfords in the banking and finance group in Sydney and had worked during various periods with Bank's Trust Plc in London and the Macquarie Bank Ltd in Sydney. Her evidence which is accepted in terms of its reliability was as follows:

"BACKGROUND TO THE ELECTRICITY SWAP MARKET NATIONAL ELECTRICITY MARKET

The National Electricity Market ("NEM") is the market for the supply of wholesale electricity by generators to retailers in New South Wales, Victoria, South Australia and more recently Queensland. National Electricity Market Management Co Ltd ("NEMMCO") operates the market in accordance with rules laid down under the National Electricity Code...

NEMMCO conducts wholesale trading in electricity as a spot market.... In essence generators of electricity provide bids as to the price at which they will supply electricity energy into the energy pool. NEMMCO then selects the generators it requires to produce electricity at 5 minute intervals and calculates a dispatch price for the interval.

The spot price (also known as the "settled" price) for a particular region is then determined as the average of the six dispatch prices for each half hour period for that region. The spot price is used to calculate the payments due to the generators for electricity supplied and the payments to be made by the retailers or other users of that electricity out of the pool. The spot price is therefore a function of the *actual* prices at which electricity has been supplied into (and taken from) the *physical* market for the supply of bulk electricity. The spot prices are publicly available on the NEMMCO web site at the close of each day....

The spot price is also used as one of the factors in settling electricity swaps as described below.

THE MARKET FOR ELECTRICITY SWAP CONTRACTS

There are three types of participants (or "players") in the swaps market: generators of electricity power, retailers of electricity power and trading houses. The generators and retailers deal in the physical market; that is they supply and acquire electricity power by participation in the NEM. Trading houses do not deal in the physical market.

Conversely the swaps market is a derivative market. The parties to swap contracts do not take delivery of electricity power, but rather make payments to one another indexed on the price of electricity in the physical market from time to time.

Generators have an inherent "long" exposure, also referred to as a "bought position". As a supplier of electricity, they have a large volume of the physical asset (namely, electricity). The price they receive for selling this asset is highly variable as a result of the way in which the market operates. It is known as a "floating" price. This gives them a long risk in both the short and longer term, as the price they receive will vary every 1/2 hour depending on the NEMMCO spot price for their particular region. Generators are therefore heavily exposed to price fluctuations. Generally generators will desire to minimise some of that risk. They can do so by "swapping" their floating price exposure to a fixed price by trading in the derivative market.

Retailers also have an exposure to the floating price because they are buying at a variable rate (and generally selling to their own customers on a fixed price basis). Accordingly, a retailer has a "short" risk in both the short and long term, in that they are constantly a seller of power which they do not as yet own. In order to cover this "sold position" and eliminate some of that risk retailers can buy at a fixed price in the derivative market.

Traders, into which category Enron fell, participate only in the derivative market by trading any position where they believe they have a pricing advantage or view that an arbitrage opportunity can be created.

The swaps market therefore provides the means by which someone with a floating rate exposure (where they are exposed to the variable half hour changes in the price for a particular region) can limit that risk by swapping the floating rate for a fixed price over a particular period. It also provides the means for a person who has a fixed exposure (for example, when someone is supplying under a fixed term contract or someone who has already entered a swap) to transfer to a floating exposure.

Because the electricity market was a relatively new and illiquid market, it did not have the well developed procedures that are typical of more highly developed and liquid financial markets....

ELECTRICITY SWAP CONTRACTS

In its simplest form, an electricity swap contract is an agreement to swap a fixed exposure for a particular type and quantity of electricity for a floating exposure for exactly the same type and quantity of electricity, or vice versa. Swaps are also known as "trades" and "contracts".

Each contract is based on half hourly floating or "spot" prices over an identified period for a particular type of electricity. The variable components which are identified for each swap are...:

Notional quantity per 30 minute period (measured in Megawatts per hour (MWh))

Effective (or Start) date

Termination (or End) date

Node

Day type

Fixed price.

The Effective and Termination dates set the start and end of the period over which the contract operates. Although the trades can cover any period agreed between the counter-parties (eg the five months that constitute a summer), they are generally for a month, quarter, half year or full year (calendar year or financial year) period.

The Node identifies the NEM area in respect of which the contract operates. The NEM areas are currently New South Wales, Victoria, South Australia, the Snowy Region and Queensland.

The Day type identifies the 3 different "rates", namely

peak: operates from 7.00am until 10.00pm on the working days of the week, but excluding any public holidays on a state basis.

off-peak: operates from 10.01pm to 7am the next day on each working day and all day Saturday and Sunday.

flat: operates seven days per week, 24 hours per day.

The fixed price is the price which the payer agrees to pay and the payee (the floating price payer) agrees to receive, calculated by reference to the electricity referred to in the swap.

The floating price is nominated as the spot price for the electricity referred to in the swap as determined under the National Electricity Code over the duration of the contract.

Each trade is settled by reference to the prices published on a half hourly basis by NEMMCO as the spot price for electricity answering the description in the trade, as I have described above. The settled value of the contract is therefore, for any particular period of time, the difference between the spot price and the fixed price originally agreed.

Contracts can be for the immediate upcoming period (eg the remainder of the current month) to as far into the future as the parties wish (eg a one year contract for the calendar year 2008). The continuum from the immediate future to the distant future, and the market prices associated with those various future periods, is known as the "curve".

TRADING IN THE SWAPS MARKET

As at late 2001 there were about two dozen active participants in the electricity swaps market. The number varies over

time, generally depending upon the views being taken by the overseas holding companies of the local traders as to whether they wish to participate at that particular time and also the views taken by local generators and retailers about their inherent risk.

All trades are over the counter ("OTC") trades. That means that each and every transaction is negotiated manually between two counter-parties rather than through an exchange.

Although participants can deal directly with one another, most participants in the market deal through specialised electricity market brokers, of which there are currently four:

ICAP Brokers Pty Ltd;

TFS Australia Pty Ltd;

Tullett & Tokyo Liberty Pty Ltd;

GFI Group Inc.

One consequence of being an OTC market is that each trade is negotiated specifically between the buyer and the seller, although often with the help of the broker. The transactions need have no specific size and no specific tenure. For example, a counter-party may want to enter a "standard" transaction for one, three, six or twelve months or a "non-standard" contract for only two or three particular months where there is no specific quarter.

Another consequence is that, because of the lack of a clearing house, each participant is exposed to the credit risk of the counter-party. The credit worthiness of a counter-party will affect the price at which that counter-party can trade contracts.

The trading procedure followed at Enron, which I understand to be typical of most of the market participants, involved traders lodging prices with a broker or brokers for a trade in which they were interested. The prices are known as "bids" or "buys" where the trader wished to enter a swap as the fixed price payer (buyer) and "asks" or "sells" where the trader wished to enter a swap as the fixed price payee (seller). The difference between the bid and the ask for any particular contract is known as the "spread".

The broker then posted the relevant bids and asks on its computer screens. Participants had access to the screens of the various brokers and could thus monitor the various quotes being placed by other participants. Traders then carried out negotiations through the brokers until such time, if at all, a deal could be done with a particular buyer or seller as the case may be. In this sense the bids and offers placed on the brokers screens operated as invitations to treat directed at potential counter-parties.

Within an hour of a deal being done the broker was required to fax a broker confirmation to each counter-party. Once a deal was done the broker disclosed the identity of the negotiating parties to the other and the relevant traders then exchanged relevant details to permit Confirmations to be completed. Within 24 hours the party identified as the documentation party in the relevant agreement between the counter parties was required to send a formal Confirmation to the counter-party for counter signature.

Trades could be done in minutes after posting a bid or ask but also might take hours, days or even weeks, depending upon the level of interest in the market for a particular price being proffered.

The OTC market for electricity swaps is an illiquid market and as such tends to have a very wide spread between the bid and offer prices, particularly as you move further along the curve. As the deals become further out in their start and completion dates, there is a spread which is far wider than is normally seen in other financial markets.

Factors which contribute to the width of the spread are the lack of liquidity in the market, the impact of not knowing the

credit rating of each participant at the initial bid and offer stage, and the fact that the quote is for five mega watt parcels notwithstanding the market could be trading 5, 10 or 20 mega watt parcels. The reality of the trading market is that the market will trade in from the initial bid and offer prices, which are essentially an invitation to treat rather than affirmed prices.

As a result of this unusually broad spread, some of the brokers quote only the last price in relation to a trade on their screens, and Enron would use this last price, as well as the feedback received from brokers, to indicate where the market was really trading at any point in time. The bid and the offer prices reflect the extremes of the market at any point in time. However, the last price is indicative of where the market is really trading at a particular time.

VALUATIONS AND MARKET ASSESSMENTS

Enron did a daily revaluation of each position it had in the market to calculate a daily value of its trading "book". I understand that most other market participants also regularly revalued their trading books. To do so Enron:

calculated the number of mega watt hours covered by each contract;

discounted the mega-watt hours back to a present value, to reflect the fact that payments are to be received in the future - Enron used a zero coupon yield curve (which assumes no significant credit risk of the counter-parties involved) applied on a monthly basis;

multiplied the sum of the discounted hours for each type of contract by a market value, derived from the Enron curve (see below), to derive the future floating flow to come from that type of contract;

derived the future fixed flow to come from each contract by multiplying the fixed price by the forward mega-watt hours for that type of contract;

the difference between the sum of the fixed flows and the sum of the floating flows determines the value of Enron's book.

The Enron curve was an analysis by Enron's traders as to the daily value of each of the various types of swaps contract in which Enron was dealing. The Enron curve was based on a number of factors including:

the AFMA curve (see below);

the prices we had seen from counter-parties each trading day;

our longer term view on the electricity market, influenced by issues such as supply we anticipated coming into the market, our estimation of user growth over various periods and anticipated outage;

Enron's future cost of capital.

The AFMA curve was published by AFMA on a daily basis.....

The AFMA curve is the forward pricing curve for electricity swaps created by AFMA based on information supplied by certain market participants. The AFMA curve is computed at the end of each trading day and published about one hour after the close of trading. It is designed to provide a market indicator of where trading for electricity finished that day per region, for peak, off-peak and flat trades.....

USA markets and Australian market

The electricity swap market has existed in the USA since the 1970's.

The electricity swap market in Australia has existed only since December 1998.

In Australia, there is generally a single market which is referred to, however, participants might only actively trade in some but not all regions of the market (the regions being New South Wales, Victoria, Queensland, South Australia and the Snowy Region). As stated in my first affidavit (refer para7.1) there were approximately two dozen active participants as at late 2001. The average parcel which is traded is 5 or 10 mega watt hours. Parcels which are larger than this are traded less regularly and parcels larger than 50 mega watts are not often traded in the Australian market.

Day end prices are published in the USA by a range of publications available generally to the public. The published prices are actual transacted prices in relation to electricity swaps for identified regions, sizes and term....

Actual traded prices can be seen on-line where larger counter-parties trade on-line. Prior to the collapse of Enron Corp, Enron Corp traded on-line; their on-line product has been taken over by UBS Warburg. Anyone who is interested in trading on-line is able to apply for registration. Once UBS Warburg has processed the registration form, the participant is able to log on to the website and view the electricity swap contracts' prices for any given region, size and term. Participants are able to purchase the contract at the screen price by simply selecting that contract...

In Australia, the AFMA curve does not provide details of actual transacted prices, and the AFMA curve is not available generally to the public. Only those parties who contribute to the AFMA curve (which is a maximum of 7) are entitled to receive the information which AFMA prepares.

The only "live" pricing information of actual transacted prices which is available in Australia are prices which are settled through a broker. However, this information is not transparent market information. Broker pricing information (via the broker screens) is available only to broker clients and is not available to the public generally. Whilst all counter-parties are entitled to be clients of all brokers, I believe that not all counter-parties are clients of all brokers.

Further, in order to make use of the broker screen prices, a counter-party needs to have the technology to track all prices throughout each trading day, to record those prices and format them into a spreadsheet which can then have a useful application for traders. Whilst Enron had the technology to undertake this task and did so, I understand that not all counter-parties are able to do this.

Comparative liquidity of the markets

As a result of there being many more active participants in the USA, the number of parties vying to purchase any particular electricity swap contract is greater. This results in there being many more bids and many more offers on either side of a transaction.

Moreover, the spread, being the difference between the highest bid and the lowest offer tends to be quite narrow, both because of the greater number of participants and the fact that the participants are more "informed" or sophisticated players.

Further, the transactions take place quite quickly, ordinarily over a matter of minutes.

In Australia where the market is less developed and less liquid (refer para4.4 and para4.5 above), there may only exist a single bid or a single offer or neither in relation to an electricity swap contract for a given region, size and term at any given time. It may take some hours for the bid or offer prices to move (ie another counter-party submits its own bid or offer in relation to the parcel). Further the spread between the bid and offer prices tends to be wider than in a more liquid market...

Generally therefore in Australia, where a counter-party is interested in a particular parcel, they will place their own offer or bid price (either directly or through a broker) and wait to see whether there is any movement over the course of some hours or even up to a day. After some time and movement in the price (the bid moving towards the offer and the offer

moving towards the bid), a price will finally be agreed which is somewhere between the initial bid and offer spread.

As is evident from para5 below, a high proportion of Integral's trades follow the general rule that the market tends towards the AFMA mid price.

The role of dealers

In Australia, whilst dealers will themselves have available the information identified in para4.9(d)-para4.9(g) above, that information is not in my experience publicly available and not transparent to the market. More importantly, in Australia, dealers are unlikely to be willing to provide external parties details of their trading data, as it is each individual party's trading data that gives them an advantage over the balance of the market, where they are able to derive from the sources in 4.26 below, data reflective of the market in a more sophisticated fashion than their competitors. This is particularly so where there is no publicly available transparent data.

Ascertaining the price at which two parties would enter into a transaction

In the USA, one can pick up a phone and get a market price (like in the bullion trade in Australia). In Australia, this can not be done. One can pick up a phone and get an invitation to treat. Where the market price lies depends on where the parties finally agree to trade.

In Australia, in order to obtain a market price, or the price at which transactions are entered into, counter-parties such as Enron would have regard to:

broker screen prices at which parties traded (ie. the screen prices at the time of the trade and not day end);

OR where actual traded prices are not available and a price need to be derived, then:

current physical prices, which indicate where the physical market is (because next years price will depend on the current price) together with:

historic price margins between the regions;

estimated forward trading margins;

any foreseen changes to supply or demand eg knowledge that SA is building a new power station, current government initiatives effecting the energy market or even simple factors such as statistics which show that more people are buying airconditioners each year; and

inflation;

current interest rates,

where no or little other data is available, the AFMA curve after exclusion of outliers, and looking at the component contributions of the curve as well as the average prices derived by AFMA, together with the known historical errors or distortions in the curve in order to make allowances.

THE AFMA CURVE

The AFMA curve is merely a survey.

AFMA requests that participants submit a bid and an offer price which represents each participants view of where the future market lies. The submissions are not transacted prices; they are each participants estimates based on whatever factors each participant wishes to take into account. To this end:

The prices submitted are reflective of a party's long term view of where the market will be trading at that future point in time. This price is not a market price of where the market is actually trading for that future point in time today.

The parties are able to submit prices reflective of their own current market position or trading strategy rather than where the market is actually trading.

In a number of cases, the submitted curve is used for counter-parties to determine their day or month end profit and loss statements. It may therefore be in a counter-parties interests to manipulate the curve in favour of their own book in order to produce favourable profit and loss statements or to avoid unfavourable swings against them.

The AFMA curve has an artificially broad spread as AFMA's guidelines outline a $2 spread on short term deals and $5 spread on long term deals. In compiling their curves, I understand that a number of counter-parties start at their mid point calculation (as most use this for their own day end revaluation) and then allocate the maximum spread AFMA will accept, to derive their submissions to AFMA.

The curve is not intended to reflect the level of actual transacted prices. There is no audit of the submissions and indeed that is not AFMA's role. AFMA accepts the submissions and enters them in the spreadsheet to derive the curve at the end of each trading day.

The differing views of contributors is evident from the schedule prepared by Mr Lonergan (refer para63 and para64 of Mr Lonergan's report and Appendix G to that report). With a range of submissions often varying in excess of 30%, when the actual market rarely moves more than 2 to 5% in a day, this suggests that the submissions reflect information other than just current prices.

Notwithstanding these significant variances in the submissions, in calculating the average bid and average offer prices, there was, at 5 December 2001, no exclusion of outlying bids and offers (refer Wayne Lonergan Affidavit at para54). This distorts the spread of the bid and the offer further.

Average AFMA bid and average AFMA offer prices are not quotations in accordance with the quotations obtained in the USA in Mr Greene's experience (refer 26). Average AFMA bid and offer prices are neither firm nor indicative quotations obtained from dealers."

Evidence given by Mr Lonergan

[51] Mr Lonergan has specialised knowledge acquired by reason of his training, study and experience on the basis of which he is entitled to express opinions as to matters concerning valuation.

[52] The Executive Summary to his report which went into evidence in terms of a sanitised version [which excluded any attempt to construe the words "Market Quotations" in the relevant definition of the subject Agreement] was relevantly in the following terms:

"I have been asked to assume and have assumed that the quotations used by a Reference Market-maker as the basis for determining a Market Quotation for outstanding contracts should reflect the market price that would be negotiated between a willing but not anxious buyer and a willing but not anxious seller acting at arms length to replace the outstanding contracts.

On that assumption that, when deriving the Market Quotation, the quotations are to be at the price at which both parties would deal, it is incorrect to assess the replacement price of the outstanding contracts:

(a) in which Integral was the seller, at the average "bid" or "buy" quote as shown in the AFMA curve
(b) in which Integral was the buyer, at the average "offer" or "sell" quote as shown in the AFMA curve

as Macquarie, Deloitte and E & Y have done.

In summary, that is because the average bid or average offer quote as shown in the AFMA curve:

(a) is not the price at which a replacement transaction would take place

(b) is an average quote not the best bid/ offer quote

(c) ignores the fact that transactions could be expected to take place somewhere between the average bid and average offer quotes

(d) has the substantive effect of granting Integral a windfall gain and imposing a penalty on Enron in contradiction of the ISDA Master Agreement requirement that no penalty be imposed.

Accenture when determining the Market Quotation, adopted as the replacement price the mid-point of the average "bid" and average "offer" quotes as shown in the AFMA curve, with some adjustments to reflect actual market transactions, having found evidence that actual transactions had occurred at about that mid-point level, rather than at the average bid or average offer level.

I believe a better indication of market price lies between the highest "bid" quote and the lowest "offer" quote. In my opinion, it would be preferable to adopt the mid-point of the highest bid and lowest offer quotes. However, I note that Accenture stated that:

"In many cases the highest bid and the lowest offer were very close to the midpoint" (of the average bid and average offer quotes excluding outliers)."

[53] Mr Lonergan carefully examined what each of the Reference Market makers had done in order to derive their replacement prices. His analysis showed that:

"Macquarie, Deloitte and E & Y value:

o the contracts in which Integral was the "seller" at the average AFMA "bid" quote (or in Deloitte case, either at the average "bid" quote or at a price very close to the AFMA average "bid" quote)

o the contracts in which Integral was the "buyer" at the average AFMA "offer" quote (or in Deloitte case, either at the average "offer" quote or at a price very close to the AFMA average "offer" quote).

Accenture's replacement price is generally consistent with (and in some cases equal to) the median and mean quote, excluding outliers."

[54] In particular he dealt with the Reference Market Makers individually as follows:

"*Ernst and Young*

o Where Integral was the "seller" the average bid quote from the AFMA curve was used. Where Integral was the "buyer" the average offer quote from the "AFMA" curve was used.

o Where the period of the outstanding contract exactly matched that quoted in the curve (and could not be broken down into sub-periods), the average bid or average offer quote as per the curve was used as a single replacement price for that contract, depending on whether Integral was the "seller" or "buyer" in the contract.

o Where the period of the outstanding contract could be broken down into sub-periods for which quotes from the AFMA curve were available, the average bid or average offer quote for each sub-period as per the curve was used as the replacement price for the outstanding contract.

o Where the period of the outstanding contract included December 2001 and continued beyond this point, the average bid or average offer quote as per the last AFMA forward curve for December 2001 (ie the 30 November 2001 AFMA curve) was used as the replacement price for the portion of the outstanding contract from 6 December 2001 to 31 December 2001. For the portion of the outstanding contract from 1 January until contract expiry, relevant average bid or average offer quotes as per the 5 December 2001 AFMA forward curve for 2002 and beyond were used as replacement prices.

Deloitte Touche Tohmatsu (Deloitte)

o Deloitte's approach to estimating the replacement price was set out in their engagement letter dated 13/17 December 2001 (note it appears a draft engagement letter was sent to Integral on 13 December 2001 and a final letter sent on 17 December 2001). In discussing the basis of the determination, they state:

"Our determination will be based on our assessment of the market prices for forward electricity contracts at the time of the unwind position. Our initial guidance will be the AFMA reference forward contract curve. We will review other market information including broker quotations, as we deem appropriate. We will take into account the normal bid/offer spread in determining the amount that would preserve the economic equivalent of your derivative positions with Enron Australia Finance Pty Ltd"

o It is apparent from their calculations contained in various accompanying spreadsheets that Deloitte relied on the AFMA forward curve to determine the replacement price. Deloitte appear to have adopted the average "bid" quote (or a price very close to the average "bid" quote) where Integral was the seller and the average "offer" quote (or a price very close to the average "offer" quote) where Integral was the buyer of the contracts. I have been unable to ascertain from Deloitte's calculations the precise mechanism they used to derive a replacement price where they have not used the AFMA average "bid" or average "offer" quotes.

o Notwithstanding the approach set out in their engagement letter, there was no evidence that Deloitte considered brokers' quotations or prices to validate or cross-check the use of the forward quotes from the AFMA curve as replacement prices.

Macquarie Risk Advisory Services Ltd (Macquarie)

o Macquarie's report was dated 2 January 2002 and set out the replacement prices used.

o Macquarie determined the replacement price based on the AFMA curve. This is clear from Mr William Dolan's report dated 2 January 2002 which states:

"Broadly, our approach has been to use the forward curves provided by AFMA (valuation date 5 December 2001) and to use the side of the spread (ie bid or offer) Integral Energy would be required to deal on to replace a contract with Enron. For example, where Integral Energy has sold a contract they must sell another contract at the prevailing market bid price (ie the price at which another party is willing to buy)."

o That is, where Integral was the "seller" the average bid quote from the AFMA curve was used. Where Integral was the "buyer" the average offer quote from the AFMA curve was used.

o Similarly to the approach taken by E & Y, Macquarie solely relied upon the AFMA forward curve when determining the replacement price. From Macquarie's internal written notes dated December 2001 (refer WRL Exhibits B6 to B10), brokers' quotations and prices were considered unnecessary in estimating the replacement price.

o There were, however, two differences in the mechanism used by E & Y and Macquarie to estimate the replacement price.

o Firstly, in cases where the contract period included December 2001, Macquarie estimated the replacement price for the portion of the outstanding contract from 6 December 2001 to 31 December 2001 by adjusting the quoted price of a December 2001 contract as at 30 November 2001 for the change in the value of that contract in the period between 30 November 2001 and 5 December 2001. Since the quoted price of a December 2001 contract was not available during December 2001, the change in the value of the December 2001 contract during the period between 30 November 2001 and 5 December 2001 was proxied by the change in the value of the January 2002 contract, which could be observed during the same period.

o In contrast, E & Y effectively ignored the possible change in value between 30 November 2001 and 5 December 2001 and used the quoted price of the December 2001 contract as at 30 November 2001 to represent the replacement price for the December 2001 portion of the outstanding contract.

o Secondly, in cases where the period of the outstanding contract did not replicate that quoted in the AFMA curve, E & Y used a different replacement price for each sub-period, whereas Macquarie generated a single replacement price for the whole contract period. However, I have been unable to ascertain from Mr Dolan's report the precise mechanism used by Macquarie to generate that single replacement price.

Accenture

o Like E & Y, Deloitte and Macquarie, Accenture had regard to the AFMA curve as the starting point to their analysis. However, Accenture's approach to estimating the replacement price is different from those adopted by E & Y, Deloitte and Macquarie in two critical aspects.

o Firstly, Accenture essentially adopted a midpoint approach between the average of the bid and average of the offer prices (after excluding certain outliers) to estimate the replacement price. In other words, Accenture adopted the midpoint of the average of the bid quotations (as adjusted) and the average of the sell quotations (as adjusted). Thus their replacement contract price is basically a midpoint, or an actual traded price, being their assessment of market price as compared to taking the (average) bid quote for replacement sell contracts and the (average) offer quote for replacement buy contracts as E & Y, Deloitte and Macquarie have done. Accenture also adopted the same price regardless of whether Integral was a buyer or seller of a contract.

o Secondly, Accenture have not solely relied upon the AFMA forward curve but also considered "actual broker trades in the market".

o As illustrated in the document entitled "Accenture - Valuation Approach", Accenture either:

"(i) chose midpoint because it was not skewed due to outliers, and represented a reasonable clearing price when analysing the data, OR

(ii) A price which correlated with some evidence of actual broker trades in the market."

o In cases where the period of the outstanding contract did not match that quoted in the AFMA forward curve, Accenture relied upon the 'adjusted market prices' which they considered as being the most appropriate to represent the replacement price for the period of the outstanding contract. The extent to which the 'adjusted market prices' represented the true replacement price appears to have been tested using:

o analysis of the volatility of AFMA prices
o broker data
o differential analysis of the AFMA prices versus seasonally adjusted market prices
o market maker research and experience."

Evidence of Mr Greene

[55] A deal of the evidence given by Mr Greene in his report concerning ISDA it has already been referred to earlier in this judgment. His experience had only been with the ISDA Master Agreement. He therefore had never had any experience with the variation imported into the ISDA (Australia) in terms of the substitution of experts becoming Reference Market-makers in the place of leading dealers. His central opinion was expressed as follows in his report:

o It is commonly accepted market practice for the non-defaulting Party to seek quotations from four or more Reference Market-makers (ie, leading dealers in the relevant market) for the non-defaulting Party's entire portfolio of Terminated Transactions.

o Where it can do so, the non-defaulting Party will seek these quotations on the relevant Early Termination Date. It will provide each Reference Market-maker (usually by fax or by telephone) with all relevant information and economic details (which may include a specimen Confirmation) in respect of each of the Terminated Transactions in advance of the time on the Early Termination Date when the non-defaulting Party has requested each Reference Market-maker's quotation (which may be at the close of business). Each Reference Market-maker will respond to the non-defaulting Party's request with its quotation (orally or, more often, in writing), which may be "firm" or "indicative."

o A firm quotation is one that the non-defaulting Party can accept if it wishes to do so (upon which it will have agreed to enter into the portfolio of proposed Replacement Transactions with the Reference Market-maker, based on the terms provided to the Reference Market-maker earlier that day, for the consideration stated in the quotation). An indicative quotation is one that the non-defaulting Party may not accept.

o Whether the quotation is firm or indicative, it represents the amount that the Reference Market-maker would charge (or pay) the non-defaulting Party to enter into the portfolio of proposed Replacement Transactions.

o No leading dealer, when asked for a quotation to enter into a proposed Replacement transaction (or for that matter a proposed new transaction), would be expected to quote a price that did not fully reflect the dealer's bid-offer spread.

o It is commonly understood in the derivatives markets that a defaulting Party bears the cost of the full bid-offer spread incorporated into a Reference Market-maker's quotation. The same is true if the Master Agreement has been terminated by reason of a Termination Event and there is one Affected Party. See Section 6(e)(ii)(1) of the Master Agreement.

o It is more common for parties to choose Market Quotation than Loss as the relevant payment measure for determining a party's loss or gain upon the designation of an Early Termination Date. Parties tend to prefer the liquidated damages available under Market Quotation to the general indemnification of Loss because of concerns as to the open-ended, subjective nature of Loss, which may turn on whether, when, and how the non-defaulting Party hedged its Transactions with the defaulting Party (issues as to which the defaulting Party will most often have no knowledge or any say). The perceived advantage of using Market Quotation (as compared to Loss) is that it spells out in advance the procedures and process for how a party is to obtain quotations from leading dealers, although ... it is impossible to predict in advance whether those quotations may be deeply discounted, or subject to a steep premium, because of unexpected market conditions prevailing on the Early Termination Date (which may or may not have anything to do with the non-defaulting Party itself or the size or complexity of its portfolio of proposed Replacement Transactions). In other words, the Market Quotation process produces an objective, market-determined measure of damages, but there is no way of knowing when parties enter into a ISDA Master Agreement whether those quotations will be representative of the non-defaulting Party's actual loss in any particular case.

o Sophisticated commercial parties ... are prepared to accept the fact that quotations may not be representative of the non-defaulting Party's actual loss because Market Quotation constitutes liquidated damages and, when it applies, no other amounts are recoverable by *either* of the parties: not by the non-defaulting Party, even if its actual loss proves to be greater than its Market Quotation, and not by the defaulting Party, even if the non-defaulting Party's actual loss proves to be less than its Market Quotation. This symmetry of result provides both parties with an important measure of

certainty that is not present when Loss applies and helps explain why the parties to an ISDA Master Agreement agree up front that Market Quotation is "a reasonable pre-estimate of loss and not a penalty."

Findings as to the AFMA curve

[56] The evidence in short establishes the following:

o That the AFMA curve is a forward pricing curve based on information supplied by only certain market participants.

o That it is computed at the end of each trading day and published about 1 hour after the closing of trading and is designed to provide a market indicator of where trading finished that day per region, for peak, off-peak and flat trades.

o That it is a survey based on input and does not reflect the prices at which parties would *actually* be prepared to trade and bids and offers which are capable of acceptance. It is, accordingly, not to be compared with, say, SEATS, the trading system on the ASX.

o That the curve shows the averages, based on information provided, of "bids" and "offers", respectively. It also shows the mean and median of the submitted "bids" and "offers".

o That prior to March 2002 the curve did not even exclude outliers and had the limitations inherent pointed out by Mr Lonergan who was not cross-examined on it at all. Its inherent failings were also exposed by Ms Mason. She also was not relevantly cross-examined in relation to this matter.

o That Mr Lonergan conducted an exercise of how the Reference Market-makers derive their prices. A graphic representation of this is set out in para82 of Exhibit P4 read with Appendix F. Appendix F shows, by way of examples, that Macquarie took the precise figure representing, down to the last cent, the figure on the AFMA curve shown as the average of the offers and bids, respectively, on 5 December 2001. This exercise involved no calculation at all but simply taking a figure off the AFMA curve representing one side of the figures submitted by the contributors to AFMA.

o That Accenture took the median or very close to the median off AFMA (5/12/01).

o That Ernst & Young, like Macquarie, took the figures, also down to the last cent, off the AFMA curve.

o That Deloitte took a figure very close to one side of the spread, and, as Mr Lonergan deposed in his statement (para64), it is apparent that Deloitte relied on the AFMA curve and appears to have adopted the average bid quote (or a price very close to it) where Integral was the seller and vice versa with respect to where Integral was the buyer.

o That Deloitte gave a report dated 21 December 2001 which is what was used by Integral to make its demand.

o That Accenture also provided what appears to be a preliminary document.

o That on the assumption that when deriving the Market Quotation, the quotations are to be at a price which both parties would deal, it is simply incorrect to assess the replacement price:

> (a) where Integral was the seller, at the average bid shown in the AFMA curve; and
> (b) where Integral was the buyer, at the average offer shown in the AFMA curve.

Findings as to the effect of what was done

[57] Clearly enough Enron is the "defaulting party" in each case and Integral is the "non-defaulting party" or "such party" referred to in the definition of Market Quotation.

[58] As the Figures above reveal, when Integral is the buyer (fixed price payer) it is in its interest for the commodity to have the *highest* value because replacing the contract is worth more to it - this is so whether the price has risen or fallen. The highest value for the electricity when Integral buys is the "ask" or "offer".

[59] Concomitantly, when Integral is the seller (fixed price receiver) it is in its interest for the commodity to be as *cheap* as possible so that the money it receives for it has a greater economic value. The lowest value of the electricity when Integral sells is the "bid".

[60] The effect of what *was done* was to determine that when the Reference Market-maker was in the position of Enron and was buying it would pay what the sellers were asking and when it was selling it would pay what the buyers were asking.

[61] Conversely, Accenture's approach was to adopt a "market" price, approximating the mid of "bid" and "offer".

Questions of principle - challenging a valuation

[62] The question falls to be decided in accordance with the test as described in Legal and General Life of Australia Ltd v A Hudson Pty Ltd (1985) 1 NSWLR 314 at 335-336 and Holt v Cox (1997) 23 ACSR 590 at 597.

[63] In the first of these cases, a valuation case, McHugh JA said at the identified pages -

"In my opinion the question whether a valuation is binding upon the parties *depends in the first instance upon the terms of the contract, express or implied*. This was pointed out by Sir David Cairns in the Court of Appeal in Baber v Kenwood Manufacturing Co Ltd [1978] 1 Lloyds Rep 175 (at 181). A valuation obtained by fraud or collusion can usually be disregarded even in an action at law. For in a case of fraud or collusion the correct conclusion to be drawn will almost certainly be that three has been no valuation in accordance with the terms of the contract. As Sir David Cairns pointed out, it is easy to imply a term that a valuation must be made honestly and impartially. It will be difficult, and usually impossible, however, to imply a term that a valuation can be set aside on the ground of the valuer's mistake or because the valuation is unreasonable. The terms of the contract usually provide, as the lease in the present case does, that the decision of the valuer is 'final and binding on the parties'. By referring the decision to a valuer, the parties agree to accept his honest and impartial decision as to the appropriate amount of the valuation. They rely on his skill and judgment and agree to be bound by his decision. It is now settled that an action for damages for negligence will lie against a valuer to whom the parties have referred the question of valuation if one of them suffers loss as the result of his negligence: Sutcliffe v Thackrah [1974] AC 727; Arenson v Arenson [1977] AC 405. But as between the parties to the main agreement the valuation can stand even though it was made negligently. *While mistake or error on the part of the valuer is not by itself sufficient to invalidate the decision or the certificate of valuation, nevertheless, the mistake may be of a kind which shows that the valuation is not in accordance with the contract.* A mistake concerning the identity of the premises to be valued could seldom, if ever, comply with the terms of the agreement between the parties. But *a valuation which is the result of the mistaken application of the principles of valuation may still be made in accordance with the terms of the agreement. In each case the critical question must always be: Was the valuation made in accordance with the terms of a contract?* If it is, it is nothing to the point that the valuation may have proceeded on the basis of error or that it constitutes a gross over or under value. Nor is it relevant that the valuer has taken into consideration matters which he should have taken into account. The question is not whether there is an error in the discretionary judgment of the valuer. It is whether *the valuation complies with the terms of the contract*."

[Emphasis added]

[64] In the second of the cases, also a valuation case, Mason P noted at 595 the common ground that a valuation was binding upon the parties unless it could be demonstrated that it was not made in accordance with the contract, referring to Legal and General Life of Australia Ltd v A Hudson Pty Ltd and a number of decisions which had followed the reasoning in that case. His Honour said at the pages earlier identified:

"A close reading of McHugh JA's judgment in Legal & General indicates that his Honour was not propounding the view that a valuation will stand regardless of error. Rather he was making the point that mistake is not itself a ground of vitiation: see also Wamo Pty Ltd v Jewel Food Stores Pty Ltd (1983) ANZ Conv R 50. A valuation may contain factual error or embody consideration of matters which should not have been taken into account, but it does not follow that the result is outside that which the contract contemplated would be within the realm of determination by the valuer. As McHugh JA makes plain, 'in each case the critical question must always be: Was the valuation made in accordance with the terms of [the] contract? If it is, it is nothing to he point that the valuation may have proceeded on the basis of error or that it constitutes a gross over or under value' (emphasis added). The statement in the next sentence ('Nor is it relevant that the valuer has taken into consideration matters which he should not have taken into account') must be read in the same context. His Honour is not saying that these matters are never relevant. Rather he is saying that they are not relevant if the valuation was in accordance with the terms of the contract.

I have already mentioned Sir Frederick Jordan's apophthegm about 'mistakes and mistakes'. It was uttered in a mandamus case. It seems to me that administrative law provides a useful analogy in the present context. There, the decision maker has an area within which he or she may make mistakes, even conferred, or exposing the decision to quashing. It is only those mistakes which involve a failure to address something which the statute requires to be taken into account that will expose the decision to judicial review on jurisdictional grounds: Sean Investments Pty Ltd v MacKellar (1981) 38 ALR 363 at 385 (Deane J); Minister for Aboriginal Affairs v Peko-Wallsend Ltd (1986) 162 CLR 24 at 39; 66 ALR 299. *The criteria of discrimination between 'mistakes and mistakes' are not determinable in advance*: cf R v Australian Broadcasting Tribunal; Exparte 2HD Pty Ltd (1979) 144 CLR 45 at 49; 27 ALR 321."

[Emphasis added]

The nature of the mistake Whether the experts carried out the task which they were appointed to carry out The Construction Issue

[65] Gleeson CJ recently described the proper approach to contractual construction in Wilson v Anderson [2002] HCA 29 at para[8] -para[9]:

"[8]...The law of contract seeks to give effect to the common intention of the parties to a contract. But the test is objective and impersonal. The common intention is to be ascertained by reference to what a reasonable person would understand by the language used by the parties to express their agreement. If the contract is in the form of a document, then it is the meaning that the document would convey to a reasonable person that matters. The reason for this appears most clearly in the case of commercial contracts. Many such contracts pass through a succession of hands in the course of trade, and the rights and liabilities of parties other than the original contracting parties are governed by them. As Lord Devlin observed, writing extra-judicially, it is only the document that can speak to the third person. In the case of a will, or a deed, or other written instrument, the object of a court is to discover, and give effect to, the intention of the testator, or parties; but it is in the meaning of the instrument, discovered according to established principles of construction, that such intention is found."

[66] It is an established principal of construction that a commercial contract should be given a business like interpretation. This requires attention to the language used by the parties, the commercial circumstances which the document addresses, and the objects which it is intended to secure: McCann v Switzerland Insurance Australia Ltd (2000) 75 ALJR 325 at 329 [22], 336-337[74].

[67] The heart of the dispute between the parties concerns what is in essence a simple question of construction. Did the ISDA (Australia) require the Reference Market makers in furnishing quotations:

§ to strive to determine or assess *the market value* of a replacement transaction; or

§ to provide that figure which they considered to be the amount which, if a dealer were quoting on the Early Termination Date, that dealer would *quote* to be prepared to enter into that transaction.

[68] In my view the phrase "that would be paid" appearing early in the definition is a clear pointer to the correctness of the former construction. The definition of "Market Quotation" requires the Reference Market-maker to determine the amount *that would be paid* to the non-defaulting party, or by the non-defaulting party, as the case may be. This means that he must determine the amount that would be paid and received in each instance, ie the price at which both parties would deal. That, I accept, would inevitably yield the market price.

[69] What is called for by means of a quotation is *not* the amount which the person giving a quotation *quotes* as what he would be prepared to pay or accept, for the acquisition or sale as the case may be, to enter into each particular replacement transaction. To the contrary, it is the market value which is required to be determined or assessed. The market value, it is well established, is the price at which a willing, but not anxious, buyer would pay a willing, but not anxious, seller: Spencer v Commonwealth (1907) 5 CLR 418 at 432 and 441.

[70] The construction springs from a careful examination of the context in which the early termination mechanism is engaged. Whilst clearly the words used in the definition of "Market Quotation" and the change from on the one hand the umbrella Agreement provision for Reference Market makers to be leading dealers, to on the other hand, the ISDA (Australia) requirement for the Reference Market makers to be experts, together with the whole of the terms of the ISDA (Australia), call for very careful examination, this is a case in which a focus confined to the cross emphases:

§ the plaintiff's emphasis of the words "that would be paid to";

§ the defendant's emphasis of the word "quotation"

whilst pointing in the direction of the proper construction, will not necessarily throw up a ready answer. However as Gleeson CJ said in Wilson v Anderson [2002] HCA 29 at para9:

"common law ...principles of construction frequently demand consideration of *background, purpose and object, surrounding circumstances, and other matters* which may throw light on the meaning of unclear language." [Emphasis added]

[71] That is why it is so very important to go back to examining the workings of the market and the common sense fairness of the situation providing for a close out mechanism to deal with events of default in order to determine, by reference of course to the words in the agreement, what the parties are seen to have intended. One is looking at the ISDA (Australia) and not at the umbrella Agreement. One is looking at the circumstance in which there were clear departures in the Australian environment from the overseas environment. One is looking to understand why it was so important to appoint experts in the Australian environment and then one needs to follow how those experts could have been anticipated by the parties acting reasonably as relevantly carrying out or being able to carry out their particular tasks. One is looking at an illiquid market. One is looking for the construction which fits the aim of the agreement and corresponds with commercial good sense as well as being linguistically acceptable. As put by Lord Wilberforce in Prenn v Simmonds [1971] 1 WLR 1381 at 1385, in citing Cardozo J in Utica:

"if it can be shown that one interpretation completely frustrates [the commercial or business object, of the transaction, objectively ascertained], to the extent of rendering the contract futile, that may be a strong argument for a particular interpretation. In truth one is inquiring *beyond the language and seeing what the circumstances were with reference to which the words were used and the object, appearing from those circumstances, which the person using them had in view*." [cf Wilson v Anderson (supra at para8 and para9 per Gleeson CJ]

[72] First and foremost the definition takes one to the amount that would be *paid* which it seems to me does indicate a *market value* requiring to be determined. An economically rational party would only trade at market value. This was the effect of the oral evidence as well as the evidence in the form of a report given by Mr Lonergan. It is also a matter which represents the common sense of the situation. If the only available price on offer departed to a material extent from market value, such a party would, all other things being equal, simply not pay that price but would come to some other commercial arrangement (or defer trading until a realistic market price was quoted). This again emerges from the

evidence given by Mr Lonergan and again it is a matter which represents the common sense of the situation. In addition it is reasonable to expect that, in due course, such "out of the market" quotes would disappear.

[73] As the plaintiff submitted, indicia supporting this construction include the following:

(a) the very use of the term "Market Quotation" [the term used is not "Quotation" but is "*Market* Quotation]

(b) the Reference Market-maker would be assumed to act rationally and a rational person would not pay more or be prepared to take less than market value;

(c) the figure is to represent the economic equivalent of the bargain - the thing which is to equate will always itself be derived from the market;

(d) the clear purpose is to create equivalence, not to penalize the defaulting party or reward the non-defaulting party;

(e) the Reference Market-maker is to identify the consideration for "an agreement", ie a transaction in which *both* parties agree;

(f) true and genuine parties would act in their interest. Neither would simply capitulate.

[74] Market value is not the price at which the seller would sell, but at which the buyer would not buy.

[75] Nor is market value the price at which the buyer would buy, but at which the seller would not sell.

[76] Further on the approach adopted and contended for by the defendant, the price would be different depending on whether Enron was the buyer or the seller. Conversely, the approach for which the plaintiff contends leads to one price whether Enron is the buyer or seller. This, I accept, demonstrates the illogicality of the defendant's construction.

[77] To the extent that it be necessary to endeavour to follow why it may be that the manner in which the event of default/early termination mechanism has been dealt with overseas in relation to those countries where the ISDA regulates their dealings, I accept that in a liquid market one anticipates that the construction for which Integral here contends may *very well* throw up a result which may be anticipated as likely to be *at least within a reasonable range* of the market value of a replacement transaction. Not only was this the evidence - which follows from the spread, ie the difference between the highest bid and the lowest offer, being quite narrow (both because of the market liquidity and the greater number of participants), but also because of the participants being more "informed" and sophisticated players. But it also follows as a matter of logic when one takes into account the consideration that:

> o the market being liquid;
> o the requirement to approach leading dealers (as opposed to experts who *can only gain their information from inter alia dealers*)

must lead to those leading dealers having a reasonable understanding of the relevant *bid* range operative within their dealing house as well as of the relevant *ask* range operative within their dealing house and may well, by dint of industry awareness, have a reasonable perception of the relevant *bid* and *ask* ranges of their competitors. Hence in that circumstance, at the least it may be said that any perceived unfairness in quotations being given by Reference Market-makers, either as the price at which as buyer, they would buy, or at the price at which as seller, they would sell, would not likely throw up anything like the disparity in the ultimate figure which that operation would be at least reasonably likely to throw up in an illiquid market and particularly in an illiquid market where the tools at hand, in terms of the grave limitations of the AFMA curve exposed by the evidence, are taken into account.

[78] The defendant's proposition is that Mr Lonergan's approach had ignored cl6(e)(iv) which refers to payment for loss of bargain and loss of protection against future risks. I accept that this contention is misconceived because what is being considered is a *replacement* transaction and the value of a replacement transaction will put the non-defaulting party in

the selfsame position as it would have been in. As the plaintiff submits, the market will value the protection and at least on the evidence of Mr Lonergan which is accepted, the market value will accordingly always include the value of the bargain and protection.

[79] Notwithstanding the close submissions addressed by the defendant [final written submissions para131 et seq] suggesting that the plaintiffs diagrams earlier set out are incorrect for the reason that they are said to describe as the "floating price", what ought to have been described as the future price of replacement swaps for the balance of the term of the terminated swap, in my view the proper construction is as set out earlier in this judgment. I do not see that the construction the subject of the above reasons is incorrect simply because for a dealer (or market participant) to take over the obligations of Enron in any swap contracts, the price to be paid in order for the new counterparty to take over Enron's obligations will or may reflect any shift in the fixed-price that has to be paid over the remaining number of payment periods to balance the variable payments flowing in the opposite direction over those same payment periods.

Findings in relation to whether the parties are shown to have been aware of the overseas ISDA Master early termination practice

[80] In my view it is clear that the defendant has not established any such awareness. No direct evidence was called by any representative of Integral as to any such awareness. The few scattered documents which went into evidence concerning agenda for meetings in relation to the ISDA documentation and the suggestion that possibly Enron holding company representatives or Enron Australian representatives may have attended and acquired certain knowledge of the workings of the overseas ISDA Master early termination practice fell light-years short of proving *what was necessary to be proved* by the defendant on this leg of its case. It is drawing a very long bow indeed to suggest that without calling clear direct evidence in this regard one can establish with any precision, let alone the necessary precision, that the parties by reference to previous dealings must be taken to have intended that a particular practice said to operate in terms of the ISDA Master in overseas electricity derivatives markets would have that same operation in relation to the ISDA (Australia). The finding is that this was not established on the evidence. The court cannot infer such a significant factual matter from the extremely limited evidence presently before the court in that regard. Further one is not dealing with a simple extrapolation but with changes already referred to in relation to the terms of the relevant agreement and a need for an evidentiary inquiry into the understanding of the parties as to why these changes were appropriate in the Australian circumstance which must involve

(i) a further inquiry at an evidentiary level as to how the 'expert' approach was seen to be workable and/or

(ii) more particularly, as to how the parties must reasonably be inferred to have regarded that approach as being able to be operated in the Australian environment.

The nature of the alleged mistake What task did the experts say they had carried out? What task were they appointed to carry out? What task did they carry out? What, if anything, does their exercise say about any common industry understanding operative in relation to ISDA Master or ISDA (Australia)?

[81] A close examination of the materials in evidence make the point that, presumably whatever their instructions, or their understanding of the contractual documents in those cases where it is clear that they had access to the ISDA(Australia), Deloitte, Macquarie and Ernst and Young appear to have in fact seen their task as having to determine the *relevant market prices*. I note that in extracting sections from the relevant correspondence in what follows, my own emphasis has been given where appropriate. The problem is that they have been shown on the evidence to have done no such thing.

[82] Why this occurred is not altogether easy to fathom. It is however important to revert to the clear difficulties which appear to have inhered in the variation from the ISDA Master requirement that the Reference Market-makers be leading dealers to the ISDA (Australia), where the Reference Market-makers are to be and are described as "experts". There is a world of difference it would seem between, on the one hand, a contractual closeout/early determination provision which

requires leading dealers who are knee deep in their ongoing and dynamic business of dealing on both sides of the market and who are asked to furnish a quotation, and on the other hand, a contractual closeout provision which requires an expert who may not be, and presumably will often not be a dealer, to carry out a task which will involve, but not necessarily exclusively, communications with dealers, in an attempt to find out what their perceptions may be as to where the market may have been at a particular point in time and/or as to where they believe they would have quoted *had they* been asked. Whatever the reason for the variation leading to the Australian experience of the requirement to appoint experts [apparently the reason was that there are no leading dealers in Australia] the court is here faced with the need to construe ISDA (Australia) and against the proper construction of *that* agreement, to identify whether what the experts did may be said to be vitiated as having simply failed to provide an opinion/figure which complied with the terms of the contract.

[83] It does seem that the evidence given by Mr Greene and in particular his explanations as to how things might work in an active market where there are numerous leading dealers, furnishes support for the plaintiff's construction. In an active market where dealers are actually doing business they will quote a price in the context that there are other dealers who may be vying for the same business, and they will, it may be inferred, want to do the business themselves.

[84] As the plaintiff's point out in their submissions, out of four leading dealers it follows that if they wanted to do the business the prices they would quote would ultimately yield market value or *sufficiently close to such* for any variation to be immaterial in any event.

[85] I accept that the position here is a fortiori where ex post facto, an expert can garner information about the prices at which deals were actually done at the relevant time. As already noted this is particularly important where there is an illiquid and thinly traded market such as in Australia. The bid-offer spreads can here be extremely wide. Acceptance of Integral's construction permitting pricing off bid/offer values would, as Accenture pointed out, treat each contract individually and *'cherry pick' the bid/offer spread*.

[86] This is the factual matrix against which the contract requires to be construed.

[87] The essential difference between what three of the experts did and what a dealer at the time would have done is that a dealer will quote a price at which he would hope and expect to do business. The three experts here have determined prices at which they *now know* no business was done.

[88] If there were leading dealers in Australia and four of them quoted then one would expect the quotes to be within a narrow band given they are all vying for the same business.

[89] The three experts here have compounded the detriment to the plaintiff by taking an average on one side (even including outliers) and not the four best.

[90] Even before turning to examine what the experts appear to have understood to be their task and then to treat with whether the exercise which they carried out is seen to be vitiated, it is convenient to note that in giving evidence Mr Greene said that at least three of the experts here would have had it "terribly difficult" because they were trying to use their best judgments to come up with a number that they believed would approximate the number that a dealer would have come up with if a dealer had been asked. [Transcript 22 August 2002 p34]

Mark to market ["MTM"]

[91] Mark to market is a reference to a valuation by way of an assessment or estimate of the market value or market price. An acquisition at cost required to be entered into the books at the higher of cost and market value is treated with by *marking it to market*.

Initial Approach by AFMA

[92] Each of the four Reference Market-makers received a letter of 5 November 2001 from AFMA seeking to ascertain whether they had an interest in being appointed by AFMA as a Reference Market-maker for the purpose of making Market Quotations as required by the non-defaulting party to an ISDA Master Agreement. This communication although referring to Pt20 of the AFMA Guide to OTC Documents and setting out certain criteria which would be required for appointment accordingly, does not assist in having furnished any form of definition of Market Quotation.

Deloitte

[93] By letter dated 13 December 2001 headed "Draft for discussion" Deloitte relevantly advised Integral [Mr Lucas] as follows:

"The determination will provide a close out price for each contract based on the sum of...[t]he *mark to market* close out price as at [to be advised].

Basis of the determination

Our determination will be based on our assessment of the *market prices* for forward the electricity contracts at the time of the unwind valuation. Our initial guidance will be the AFMA reference forward contract curves. We will review other market information including broker quotations, as we deem appropriate.

We will take into account the normal bid/offer spread in determining the amount that would preserve the economic equivalent of your derivative positions with Enron Australia Finance Pty Ltd."

[94] The reference to the 'mark to market' closeout price as well as the reference to their assessment of the 'market prices' for relevant contracts at the time of the unwind valuation are clear indicators from which the court draws the inference that Deloitte considered that what was required was a determination of market value.

Macquarie

[95] In the letter from Macquarie to Integral of 2 January 2002 Macquarie commences by observing that Integral had requested it to "*value* the individual contracts of Integral's electricity contract portfolio with Enron has at 5 December 2001" making the point that what was being provided was a "valuation" subject to a relevant disclaimer.

[96] The letter goes on to add inter alia:

"By way of explanation:

o The Replacement Price is our estimate *of the market price* as at 5 December 2001 of a contract with the same Start Date and End Date as the original contract that is to be replaced;

o MTM (Mark to market) Valuation is our estimate of *the present value* payment required (as at 5 December 2001) for each contract between Integral Energy and Enron that is to be replaced."

[97] The letter then in terms of setting out the approach taken includes the following sentence:

"Broadly, our approach has been to use the forward curves of AFMA (valuation date 5 December 2001) and to use the side of the spread (ie: bid or offer) Integral Energy would be *required to deal on* to replace a contract with Enron."

[98] An Appendix by way of a disclaimer appears at the end of this letter which further underlines the point that Macquarie have sought to assess a market price for the transactions using its own proprietary models to provide a best estimate or fair value model of the transactions. The disclaimer includes the following:

"The quotations are based on certain assumptions...and *current market conditions*.

Because of the nature of the electricity market and the lack of liquidity in that market, it is often not possible for Macquarie to provide a definitive 'market price' for the transactions. Instead Macquarie uses its own proprietary models to provide a 'best estimate' or 'fair value' model of the transactions.

Accordingly, all quotations are indicative only. Macquarie does not make any offer to entry into transactions on the basis of the quotations. Furthermore, due to *current market conditions*, it may also not be possible for you to sell or buy equipment transactions *on market* at the quoted prices."

[99] Here again it seems to me that there is substance in the plaintiff's submission that Macquarie has gone about endeavouring to assess a market price as its understanding of the relevant exercise. This is not the same as giving a quotation. It amounts to giving a valuation.

[100] An anterior letter from Macquarie to Integral [Mr Lucas] of 12 December 2001 identified the role Macquarie would have as being to "value" Integral's electricity contract portfolio with Enron for a particular value date.

Ernst and Young

[101] Ernst and Young in their letter of 17 December 2001 to Integral [Mr Lucas] in setting out their understanding of the requirements of Integral included the following:

"As a result of an early termination, the Company as the non-defaulting Party under the ISDA Master Agreement has requested Ernst and Young as a Reference-Market-maker to provide an *independent estimate of amounts payable or receivable* under specified energy derivative contracts with Enron...For each contract, you wish us to provide a *replacement value* as at a valuation date to be specified by you"

[102] There are further indications in the Meeting Notes of 13 December 2001 [Exhibit PX p369 in volume 1A] that the approach taken by Ernst and Young was to accept that what was required was a market valuation. Likewise the letter of 16 January 2002 refers to "market quotations" and "estimates".

Accenture

[103] Accenture's letter of acceptance of 24 December 2001 made very plain that it was about an expression of Market Quotations. And on 14 January 2002 following a request for detail which had been received from Mr Lucas, Accenture that it had "*marked to market* the swaps against the moot point of the AFMA data". This is a reference to "mark to market".

[104] In the result it is clear that what the three Reference Market-makers [excluding Accenture] in fact did was seemingly and in the face of their apparent acceptance that what was required was a market valuation, to then go about an exercise which ex facie was no such thing. They identified the price at which only one party (the buyer where Integral was the seller, and the seller where Integral was the buyer) would transact. And even worse, they adopted the average of the bids and offers submitted to AFMA, whereas even an anxious seller would accept, at worst, the highest bid and even an anxious buyer, would accept the lowest offer [see the evidence given by Mr Lonergan.] As the Plaintiffs submitted they are shown to have engaged in an exercise *foreign to the contractual requirement*.

[105] The valuation approach adopted by Accenture is set out in Exhibit PX volume 1A at 517 where the two main approaches to valuing replacement cost of contracts are explained and where the reasoning given includes the following:

"Due to the usual size of the spread on bid/offer prices of $2/MWh, there may be a high level of sensitivity attached to the valuation of replacement contracts for each method. As such, in order to validate the midpoint view, Accenture also reviewed transactions in the broker market to gauge the liquidity of comparable broker trades at (or close to) the relevant date. There was some data to support prices clearing at a midpoint level and not at the bid/offer level.

o Where there was no broker data, a price around the midpoint was usually chosen

o Where there were ample broker trades for the replacement contract (on or around that date) we may have selected a price closer to the traded price

Also, the average bid/offer prices included 'Outliers' -- Using the average of the bid/offer prices this may distort the valuation. In many cases the highest bid and the lowest offer were very close to the midpoint and hence may have been used *[a diagram was then set out which is annexed to this Judgment as appendix "A"]*

In the event that counterparties may have bought and sold contracts at different prices, pricing off bid/offer values would treat each contract individually and *'cherry pick' the bid/offer spread*. Instead a forward curve was developed to have one (midpoint) price, irrespective of replacement of a sell/buy trade. This would also assist taking into account non-standard contract terms or for contracts that exceed standard AFMA posted contracts. This took into account seasonality/profiling based on AFMA data, and allowed for monthly contracts to be valued." [Emphasis added]

[106] The further result which flows is that the quotations provided were not and were not expressed to be a determination of the amount that would be paid to or by the Reference Market-makers respectively.

What, if anything. does their exercise say about any common industry understanding operative in relation to ISDA Master or ISDA (Australia)?

[107] In the unusual circumstances which obtain the actual work carried out by the experts not being explicable by reference to their own communications and falling outside the proper construction of the critical definition of "Market Quotation", no inferences can be drawn from the work carried out by them as to any common industry understanding operative at any material time in relation to ISDA (Australia).

Dealing with the demurrer

[108] The plaintiff seeks to plead the following:

Para7A

o That it is an implied term of the agreement that:

o a Market Quotation by a Reference Market-maker acting under the agreement must be given independently and without partiality to either of the parties;

o A Market Quotation which is not so given does not constitute a quotation within the terms of the agreement.

[the term is said to be implied by law and from the other terms of the agreement]

Para17A

o That the "quotations" provided by two of the four Reference Market-makers, namely those of Deloitte and Macquarie:

o Were given other than independently and without partiality;

o In the case of Macquarie, before providing its quotation and on or about 31 December 2001 its representative sought and received from Mr Tony Lucas of the defendant, the valuation number the defendant was expecting overall. It made no such inquiry from the plaintiff. Further, Macquarie sought and obtained from the defendant an Indemnity which would protect it against a claim from the plaintiff;

o In the case of the defendant and Deloitte, they were parties to a retainer letter that provided for the methodology to be

used by Deloitte without any input from the plaintiff with respect to that matter. Thereafter, Deloitte provided to the defendant, but not the plaintiff, drafts of its "quotation" for discussion and had the defendant, and not the plaintiff, review its calculations. Further, Deloitte sought and obtained from the defendant an indemnity which would protect it against a claim from the plaintiff.

[109] It is axiomatic that only the clearest case satisfying the court that no cause of action is disclosed will justify leave to amend being refused. This having been said, there is clear authority to the effect that the court will examine very carefully indeed any suggestion that no cause of action is disclosed in terms of a pleading amendment sought to be propounded.

[110] The proposition for which the defendant contends is that in the absence of a pleading of gross fraud or of wrongdoing involving:

> (1) the engaging of the subjective state of mind of the expert (who must be aware of the wrongdoing); and/or
> (2) a pre-existing state of mind disabling the decision maker from properly being able to carry out the task;

there simply is no principle permitting an expert's determination to be impugned on a procedural basis.

[111] It is plain that when one is examining the conduct of a judicial or quasi-judicial hearing there is an expectation of impartiality and adherence to procedural fairness (or what was formerly referred to as natural justice). In Kioa v West (1985) 159 CLR 550, Mason J stated the rule as follows:

"The law has now developed to a point where it may be accepted that there is a common law duty to act fairly, in the sense of according procedural fairness, in the making of administrative decisions which affect rights, interests and legitimate expectations, subject only to the clear manifestation of a contrary statutory intention...What is appropriate in terms of natural justice depends on the circumstances of the case and they will include, inter alia, the nature of the inquiry, the subject-matter, and the rules under which the decision-maker is acting...In this respect the expression 'procedural fairness' more aptly conveys the notion of a flexible obligation to adopt fair procedures which are appropriate and adapted to the circumstances of the particular case." [at 584-585]

[112] However, where what is involved falls outside the realm of judicial or quasi-judicial determination, the issue is whether the principle of procedural fairness can be or should be maintained. Framed in terms of this case, the question is whether the Reference Market-maker, called upon to give a market quotation, *must* do so independently and impartially.

[113] It is of assistance to address this issue by first asking whether the Reference Market-maker's task is to be seen as that of an arbitrator, ie. a quasi-judicial determination which will automatically invoke the principles of impartiality, or whether the task is merely that of an expert, valuer or appraiser. In Capricorn Inks Pty Ltd v Lawter International (Australasia) Pty Ltd [1989] 1 Qd R 8, McPherson J at first instance outlined the relevant factors to consider in making this determination. Although the existence of a dispute may well be seen as persuasive in determining whether an arbitration or appraisal is involved, his Honour importantly noted that:

"the existence of a dispute, although a factor, is not necessarily a decisive factor in determining whether arbitration or appraisement is involved. It is quite possible for parties to become involved in a dispute about something, such as the value of premises or goods, which they agree to submit for appraisal without intending that an arbitration should follow. The distinction depends upon a range of factors of varying importance and weight depending on the circumstances; but generally what must be in contemplation is that there will be 'an inquiry in the nature of a judicial inquiry.'": Capricorn Inks v Lawter International [1989] 1 Qd R 8 at 15.

[114] Capricorn was a case in which it had been agreed by the parties that the defendant had supplied defective printing

varnishes to the plaintiff in breach of contract and that they would resolve their dispute with respect to the quantum of damages by jointly instructing a firm of accountants to investigate and assess damages. It was agreed that the plaintiff would cooperate fully in the investigation and that the accountants' assessment would constitute a final settlement of the dispute. In an early letter before the agreement to ask the accountants to quantify damage had been reached, the plaintiff's solicitors had proposed a particular settlement figure to the defendant's and the instructions to the accountants included that they should investigate the loss as claimed in the Heads of Damage noted in the particular letter. Subsequently but without the defendant's knowledge, the plaintiff's accountant presented a greatly increased claim to the accountants' assessors which was accepted by them as the appropriate quantum. The plaintiff applied to the court to have the assessment treated as an award under the Arbitration Act 1973 (Queensland) and for judgment. The defendant applied to have the accountant's decision set aside under the Arbitration Act for misconduct. The case presents the situation of a party which had agreed to accept a simple, informal expert process to resolve a dispute subsequently being unwilling to comply with the results. MacPherson J's careful examination of the differences between an arbitrator and a valuer, assessor or expert was approved by the Full Court ([1989] 1 Qd R 22 and following). A short summary of the judgment is usefully given in "Alternative Processes in Australia: Expert Appraisal and arbitration" at p131-p132 which is acknowledged in this summary of the decision.

[115] The other relevant factors considered by the court were the nature of the inquiry and the fact that the appointment was to a firm of accountants rather than to a specific named person as would be required for an arbitrator. The accountants were to make an inquisitorial inquiry rather than an adversarial one. The parties had no right to be heard by the accountants. Thomas J in the Full Court considered the function of the accountants all-important. The arbitral function is to hear and resolve the parties opposing contentions while an appraisal or expert decision is typically an appraisal in monetary terms of property value, or of loss or damage, made through specialist knowledge, or skills without any requirement of first hearing the parties. The Full Court determined the accountants to have been acting as experts not as arbitrators but nevertheless concluded that they had acted in excess of jurisdiction by receiving and acting upon the further claim from the plaintiff's accountants. They had been appointed to consider the claims set out under the heads of damages in the particular letter and not other claims that might subsequently be presented by only one side. The defendant's appeal against summary judgment was therefore allowed.

[116] Turning to the circumstances of this case, one must recall that in relation to the ISDA (Australia), qua the determination mechanism and the appointment of relevant experts, one is dealing with a very special contractual environment. The role of the Reference Market-makers is far from that of an arbitrator. Their role is far from one which requires any input from the defaulting party and one which requires only a small amount of input from the non-defaulting party in terms of formal provision of necessary information to be taken into account in the exercise, such as the identification of the relevant swap contracts in respect of which the exercise is to be carried out.

[117] With this in mind, it is now convenient to treat with the more complex issue, namely whether an expert is to be regarded as being required to act independently and without partiality to either party. While the judgments in Capricorn are useful in addressing the distinction between arbitration and other inquiries such as expert appraisals or valuations, it is important to note that the Full Court decision was that the accountants, as auditors, acted outside the terms of their engagement established by the parties. In this regard, a subtle distinction may well exist between on the one hand, an expert acting outside the terms of their prescribed duties and, on the other hand, an expert failing to act impartially. It is no doubt conceivable that an expert asked by the parties to value certain goods may engage in conduct that lies outside the terms of their engagement, without ever acting partially to either party involved. Conversely, experts may act entirely within the general terms of their engagement in making a valuation, but do so while acting partially to a particular party. The decision in Capricorn, though useful, does not entirely address the issue arising in this case as pleaded.

[118] Absent an expert code of conduct or contractual provision requiring adherence to procedural fairness, "the issue will be whether it was an implied term of the contract that the expert would follow fair procedures, which would be difficult to oppose in general terms, but the exact extent of the duty would always be controversial.": Kendall J, Dispute Resolution; Expert Determination (London: Longman Group UK Ltd, 1992) at 119-20. It has been suggested that

"[e]ven if the parties accept that the expert is not bound to decide on the basis of their submissions there is no reason why they should not expect fair procedures to be followed, for example in any conference that might take place.": Astor H and Chinkin CM, Dispute Resolution in Australia (Sydney: Butterworths, 1992) at 136.

[119] There is of course no doubt but that a term can easily be implied that the valuation must be made honestly and impartially. McHugh J [in terms citing Sir David Cairns in Baber v Kenwood Manufacturing Co Ltd [1978] 1 Lloyds Rep 175] said as much in Legal & General Life of Australia v Hudson Pty Ltd (1985) 1 NSWLR 314 at 335, making the point that by referring a decision to a valuer, the parties agree to accept "his *honest and impartial decision* as to the appropriate amount of the valuation"]. [cf WMC Resources Ltd v Leighton Contractors Pty Ltd (1999) 20 WAR 489 at 500 where Ipp AJA followed Hudson]

[120] In Belchier v Reynolds (1749) 96 ER 1318 at 1319 Sir John Strange MR dealing with an agreement to refer to a third party the question of value, held that the parties "must abide by it, unless they could have made it plainly clear, that he had been guilty of some gross fraud, all partiality, on this occasion..."

[121] In Fredericks and Pelhams Timber Buildings v Wilkins [1971] 3 All ER 545 Sachs LJ, dealing with interpleader proceedings in which the applicant was a sheriff said:

"A sheriff who interpleads does so on the footing that he is neutral in the dispute between the parties and does not, to use a time-on a phrase, 'play on the same side' as one of them. His claim to costs depends on his conforming to this precept."

[122] Leave to amend is to be granted. The cause of action sought to be propounded throws up an arguable case.

Short minutes of order

[123] The parties are to bring in short minutes of order. Costs may be the subject of submissions.

Order

Construction put by the plaintiff upheld. The ISDA (Australia) required the Reference Market-makers in furnishing quotations to strive to determine or assess the market value of a replacement transaction.

Counsel for the plaintiff: Mr D Hammerschlag SC and Mr V Kerr

Solicitors for the plaintiff: Blake Dawson Waldron

Counsel for the defendant: Mr R Ellicott QC and Mr D Knoll

Solicitors for the defendant: Corrs Chambers Westgarth

---- End of Request ----
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