The Electricity Authority
PO Box 10041
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16 June 2020

Consultation paper - Hedge Market Enhancements

To whom it may concern,

We thank the Authority for the opportunity to make a submission on improvements to market making. Our submission should be read in the context of previous submissions to both the Authority and the WAG from emhTrade Ltd[1]. We note that the last 6-12 months have shown a considerable amount of progress and whilst it has been a long 11 years since market making was first proposed, progress now seems to be at a pace which is commensurate with the level of urgency needed to ensure enduring liquidity in the hedge markets. Credit for this progress should be extended not only to the Authority but also to the existing market makers.

Before answering the specific questions in the consultation paper, we think it worth zooming out slightly to consider the market for electricity price risk management in New Zealand.

Whilst we strongly support this particular project, the root problem is not market making reliability per se. It is in fact hedge market liquidity or lack thereof. This is largely due to the vertically integrated (VI) nature of the market.

It may well be that the level of of VI that we have in NZ is, in fact, efficient in that it may lower costs to consumers through economies of scale, shared systems, and perhaps lower transaction cost on hedging, but that does not detract from the fact that it carries a socialised cost; that hedge market liquidity is reduced, potentially to the point that the market lacks the critical mass to find efficient prices for, and enable the efficient transfer of, various forms of electricity price risk. This issue was identified both in the Brownlee reforms and more recently in the EPR.

We make this point for two reasons:

Firstly, whilst the scope of the project is market making, in order to reach the best outcome it is important to note that market making is only the current best liquidity support mechanism. Even with any of the proposed improvements, it is far from a silver bullet in terms of the wider liquidity problem - the markets for long term price risk or capacity shortfall/profile risk are still likely to remain illiquid and may benefit from other liquidity support mechanisms including, but by no means limited to, different market making obligations from that which are in place today.

[1] To the WAG Hedge Market Development discussion paper 2014 and the Authority's Hedge Market Development - Enhancing trading of hedge products consultation 2015

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Secondly, aligned with the previous submissions that we've referenced, we are concerned that the consultation paper seems to be defaulting to a beneficiary (of the proposal vs the status quo) pays approach. This ignores the fact that there is a counterfactual with no VI in which the electricity price risk market is, through necessity, deeply liquid and dynamically evolving to constantly develop and utilise the best risk management products for the market. Our view is that the cost of liquidity support mechanisms, including market making, should be borne on an escaserbator-pays basis by those parties that engage in VI (not limited to the current market makers). This would result in VI being utilised only where it is efficient from a wider economic perspective (ie after accounting for socialised costs).

In answer to the specific questions :

Question 1:
Yes we think the approaches to market making are correctly described, and don't suggest any changes to the options.

As above there are questions as to which party pays, and whether it may be appropriate to have other (next best) liquidity support mechanisms in addition to market making, but we accept that these are beyond the scope of this consultation.

We are averse to the two ends of the spectrum presented. We've seen that the voluntary approach does not achieve the necessary levels of liquidity in base-load futures (primarily due to concerns around reliability).

Similarly, the experience to date suggests that it is unlikely that a purely mandatory approach would be effective for a number of reasons. We'd expect push back on this option to be intense and ultimately lead to an extremely lengthy process to install what would be incredibly inflexible arrangements. There is also, potentially, a considerable difference between the market price for market making, and the cost to some participants of doing it themselves if mandated.

The three remaining options all allow, to some degree, for market making services to be provided by the lowest cost providers. We support this and indeed suggest that the extent to which this is possible should be a criteria for making the decision (see below).

Our support for a commercial only approach depends considerably on who pays. We wouldn't support consumers being asked to 'pay twice' for VI participants' hedging strategies.

Question 2:

The trade offs presented seem to be accurately described, however we are of the view that they miss the context within which market making operates. The question still ought to be 'how do we improve or create enduring liquidity in electricity price risk markets?'. We accept that the scope of that question needs to be reduced to market making for the sake of this project, but each approach should ultimately be judged on the extent to which it will achieve that.

We suggest that two other trade-offs would be better indicators of enduring liquidity:
The extent to which market making services can be performed by the lowest cost provider(s).
The extent to which market making obligations are likely to be optimal.

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To expand on the second point, we don't aim to bring the specifics of market making obligations into the discussion (at this juncture), but merely highlight that the approach selected may significantly impact the ability to make subsequent decisions about these details in a timely and efficient manner. For example, as new technology emerges, there may be products such as caps and floors that grow in importance (to hedge batteries for instance)… how will the choice of approach influence the ability of market making as a liquidity support mechanism to evolve with those sorts of potential structural changes? Some of the options presented would make these sorts of changes, iterations and optimisations far more timely and lower cost than others.

Please don't hesitate to contact me to discuss any aspect of this submission, the dialogue-centric approach to stakeholder engagement to date is something that we've appreciated. We look forward to seeing continued momentum with regards to more liquid and enduring markets for electricity price risk in New Zealand.

Yours Faithfully,

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