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Hedge Market Enhancements – Market Making

Genesis Energy Limited (**Genesis**) welcomes the opportunity to respond to the Electricity Authority's (**Authority**) consultation paper *Hedge Market Enhancements – Ensuring Market Making Arrangements are Fit for Purpose* dated 21 April 2020.

Evidence based approach commended

While there is room for improvement, neither the New Zealand electricity futures market nor the current market making scheme is broken or failing. Accordingly, changes to market making, and the extent to which regulatory intervention should support these, should be considered carefully.

We therefore support and commend the Authority for seeking to take an evidence-based approach to reviewing the current market making arrangements. This has been reflected in the 2019 consultation on market making, the current consultation, the Authority's efforts to facilitate an industry working group discussion on an incentive based market making scheme and the reporting on market making metrics and activity which the Authority has published this year.

Scheme design informed by market feedback and price discovery likely to be fit for purpose and enduring

In our submission to the Electricity Price Review Panel on the issue of market making, Genesis:[1]

- Agreed that the market making scheme in place at the time should evolve to ensure it is fit for purpose and durable for the future, especially during times of volatility and market stress.

[1] Genesis submission on EPR Options paper

- Advocated for the implementation of an incentive based scheme as soon as practicable, with the appropriate regulatory safeguards.

- Explained why an incentive based scheme should be quicker to implement compared to other jurisdictions such as Singapore.

We reiterate these views and for the reasons set out in this submission and the enclosed working group report, consider that that an incentive based scheme (with a mandatory scheme as a back-up) which has been developed through a competitive market feedback and price discovery process is more likely than the other approaches set out in the consultation document to result in a scheme that is flexible, resilient, cost effective, with service levels appropriate for the New Zealand context. In short, a market making scheme that is, and remains, fit for purpose, and which delivers long term benefits for consumers.

Market makers and non-market makers agree key principles for an incentive based market making scheme

We thank the Authority for facilitating discussions between a group of market makers and non-market makers[2] on a market led approach to an incentive-based market making scheme (**Working Group**).

The Working Group unanimously agreed on key principles and high-level design elements for an incentive based-market making scheme. These were recorded in a report dated 27 May 2020 (**Working Group Report**).

Of particular significance, was the agreement by market makers and non-market makers that, at the heart of any market making scheme, should reside the principle that beneficiaries of market making services should meet the costs of those services. The consequences of doing otherwise, include a more costly, inefficient and inequitable scheme.

We reiterate our support for the principles and design elements contained in the Working Group Report, a copy of which is enclosed with this submission.

Schedule 1 to this letter sets out in more detail our response to the specific questions raised in the discussion paper.

[2] Contact, Genesis, Mercury, Meridian, Nova Energy, Pioneer Energy, TrustPower.

Please don't hesitate to contact me by email: warwick.williams@genesisenergy.co.nz or by phone: 021 225 6623, should you wish to discuss any of the matters in this submission further.

Yours sincerely

Warwick Williams
Senior Regulatory Counsel | Group Insurance Manager

SCHEDULE 1
RESPONSE TO CONSULTATION QUESTIONS

Question	Comment
1	**(a) Has the Authority correctly described the approaches above? If not, please identify any changes to the approach description.** There are a range of approaches that span the spectrum between a purely voluntary and purely mandatory market making scheme. We do not think that all six were necessary, for example, as discussed below, Approach 5 (Mandatory with transferable providers) should not be a standalone approach. However, the six approaches described by the Authority provide a useful starting point for thinking about the different options and trade-offs.
	(b) Are there any other approaches the Authority should consider? If so, please provide a brief description of the approach and its merits. We recommend that each approach, including Approach 6 (Mandatory), should allow participants to contract a suitably qualified third party to provide the market making services on its behalf. Provided appropriate safeguards are put in place, and the participant retains ultimate responsibility for those services, this flexibility: (a) allows market makers, including under a mandatory scheme, to identify the most efficient and low-cost way of providing services (particularly, if its circumstances changed so that outsourcing was the appropriate option); and (b) provides the potential for a more diverse group of market makers.

(c) Do you have strong preference or strong aversion to any of the approaches outlined? Please explain your reasoning.

We strongly support Approach 3 (Commercial), supported by a mandatory "backstop" scheme. An approach that allows market feedback on both design and price (particularly, from parties other than the current market makers), provides the Authority with valuable information with which to assess its design choices. This includes: informing the Authority's cost benefit analysis; obtaining data from current and prospective market makers on the costs of market making services at different service levels; and testing assumptions on the cost and service levels for an enduring scheme in New Zealand. Importantly, this information should make transparent the trade offs between reliability, service levels and cost so that an informed decision can be made.

We are a co-signatory of the Working Group Report and reiterate for the reasons set out in that report that:

- Irrespective of the nature of the scheme, beneficiaries of market making services should pay for the services.
- Service levels must be appropriate for the New Zealand market.
- The process to reveal least cost service providers should be competitive, and details of mandatory fall back scheme must be confirmed ahead of the RFP process.
- Transparency and simplicity are to be preferred.
- The following design features are critical to a resilient and enduring scheme:

  (1) The specifications of the market making scheme – i.e. the minimum service requirements expected of market makers and the consequences for non-compliance.

  (2) The method used to determine the size of an incentive pool.

(3) The method used to determine how the incentive pool is distributed to market makers.

(4) The method used to fund the incentive pool from the beneficiaries of market making.

- The design and price discovery process should be a two-stage competitive process: Stage 1: Expressions of Interest (**EOI**); and Stage 2: A binding tender (**RFP**) process.

In short, a scheme design that is informed through market feedback and price discovery, is likely to be more flexible, cost-effective (relative to the service provided), resilient and fit for purpose.

We make the following additional comments:

Competitive design and price discovery process

The two-stage process need not be lengthy or drawn out. The Authority and the industry have been considering potential approaches for some time and there is precedent with the existing scheme and overseas (e.g. Singapore).

With the current voluntary agreement as a starting point, and feedback obtained by the Authority from this consultation (including the Working Group Report), the EOI documentation can be put together and the process run (we recommend with the help of the ASX), with say a 10 – 15 working day deadline for responses. The critical phase would be the framing of the key design elements (e.g. service levels, pricing sensitivity, no. of market makers, volumes and spreads, penalties) to ensure that the Authority receives high quality feedback with which to refine the specifications for the RFP (and the mandatory market making scheme if the incentive scheme fails).

Transparency and simplicity should be preferred in scheme design, with the ability for the scheme to evolve if required through subsequent reviews and RFPs (see discussion below).

The RFP design and documentation can then be prepared and issued, with a similar 10 – 15 working day deadline for responses.

In terms of indicative timing, we suggest: Stage 1 (July – August 2020) and Stage 2 (September – December 2020).

In summary, with the momentum and information generated by this consultation, we suggest that there is an opportunity to complete the RFP process by the end of this calendar year, with a fit for purpose market making scheme ready for implementation (subject to decisions on funding and the funding method (for example, if through a budget appropriation) in 2021.

Importance of Review

It is important that the scheme is subject to review to ensure the scheme remains resilient and fit for purpose. This could be done through the Authority seeking feedback from market makers and beneficiaries at least three months before the 12 – 15 month initial contract ends to inform its decision on any changes that may be required. We do not anticipate that another two-stage competitive process would be required to provide this review.

Measures of success

We acknowledge that the Authority is aware of the importance of clarity on what the measures of success are. We suggest that the proposed measures and the means by which they will be measured and reported, are made explicit in the EOI so that the Authority obtains useful feedback to inform the decisions on the related trade-offs. For example, if reliability during market stress is principal measure of success, then the relevant criteria (and the range of consequences for failure) should be set out in the EOI for feedback.

Beneficiaries and funding / cost allocation model

While the Authority will determine who the beneficiaries are, and the extent that they should contribute to costs of market making, we encourage an approach that favours transparency and simplicity in the first instance, with the opportunity for subsequent review prior to contract re-tendering as discussed above. In terms of how the costs might be

	funded/allocated, we note that the Working Group Report provides potential options for the Authority to consider including allocating the cost between generators and purchasers of load. We recommend a funding/cost allocation model where the costs are funded by solely by retailers and purchasers of load for the following reasons: • While there are different categories of beneficiaries who derive different benefits from market making, the Electricity Price Review Panel's recommendation concerning market making, and the key driver for the current review, is based on the perception that the current scheme has not been reliable during times of market stress, particularly in relation to near term futures contracts. • Applying this lens, it is the risk management benefits to retailers and purchasers of load that a resilient market making scheme provides that is most valued in contrast to other benefits such as price signals (we note that investment decisions tend to be based on long term rather than near term electricity prices). Accordingly, we recommend that the Authority impose the levy to fund the market making scheme (whether voluntary or mandatory) on purchasers of load. • While not perfect, this is broadly equitable in that it is aligned to the key benefits that critics of the current scheme are seeking, is transparent and simpler to administer. Pursuing an allocation/funding model that seeks to capture all the beneficiaries of the service in proportion to the benefits received would be complex, costly and difficult to administer, and could lead to unintended consequences (for example, if the model were seeking to impose costs on financial / non-industry entities through ASX fees, this could drive participants to use the OTC markets more).
2	**(a) Has the Authority correctly described the trade-offs above? If not, please identify any changes to the trade-offs.** While the matrix is a useful way of assessing key variables from the Authority's perspective, we would characterise these differently. That is, as key assessment criteria rather than trade-offs. We consider that the "Can involve markets in the design of services" trade off goes to reliability as well efficiency. As the Authority acknowledges, different levels of

	reliability come with commensurate levels of cost. A voluntary scheme can provide the level of reliability required provided the beneficiaries are prepared to meet the cost. Similarly, a well-designed commercial scheme, could through incentive arrangements, incentivise market makers to continue market making where one or market makers have not.
	(b) Are there any other trade-offs the Authority should consider? If so, please provide a brief description of the trade-off and its importance No – while we might have described the criteria differently, the key criteria are captured within the concepts of reliability, efficiency (which includes cost) and confidence.
	(c) What trade-offs are most valuable to you, and which are the least valuable to you, and why? For the reasons set out in the Working Group Report and in our responses above: • Involving markets in the design and price discovery • Increasing the number of market makers • Increasing the diversity of market makers • Allocating costs to beneficiaries
3	**(a) Has the Authority correctly assessed each approach against the key trade-offs? If not, why not?** We query the assessment that the commercial approach scores neutral in the ability to increase the number of market makers. A well-run process (which includes details of the mandatory fall-back scheme) should result in a scheme design that is informed by market feedback and price discovery. We suggest that this would be more likely to increase the number and diversity of market makers than a mandatory scheme. Similarly, the assessment of a purely voluntary approach against the number and diversity of market makers criteria only holds if it isn't a purely voluntary approach. The current scheme, which has no incentive payments, has had the regulator request changes to service levels and which currently operates with the threat of further regulatory intervention, is

	unlikely to attract new market makers. In contrast, we would expect a truly voluntary scheme co-designed with the market is more likely to attract a larger and more diverse pool of market makers, and with the right incentive structure, incentivise market makers to continue to market make when others do not.
	(b) If you have identified any changes to the approaches or key trade-offs in questions one and two, please provide your assessment of those approaches and/or trade-offs. Please see our response to 3(a) above.

SCHEDULE 2

WORKING GROUP RECOMMENDATIONS ON KEY PRINCIPLES AND DESIGN ELEMENTS FOR AN INCENTIVE BASED MARKET MAKING SCHEME

The Authority will publish this after formal receipt by the Board