Mercury

Electricity Authority
By email: HME.feedback@ea.govt.nz

16 June 2020

Submission on Consultation Paper: Ensuring market-making arrangements are fit for-purpose over time

Mercury welcomes the opportunity to comment on the Hedge Market Enhancements Marking Making consultation paper.

Mercury supports a liquid and robust electricity futures trading market

The electricity futures market provides an essential role in promoting efficient outcomes in the New Zealand Electricity Market by enabling the management of spot price risk and informing a range of investment and operational decisions through the discovery of a forward price curve. These benefits accrue to participants across the entire supply chain, including large electricity users, independent retailers and independent generators who may hedge spot price risks using futures contracts directly or benefit from efficient price discovery in negotiating over the counter contracts for difference (CfDs). Prices indicated by the forward price curve can signal the need for investment. A liquid and deep futures market also supports effective retail competition.

Mercury is committed to improving the current arrangements and contributing to a more sustainable outcome. This will benefit all market participants that rely on efficient price signals from the futures market.

This review of the market making arrangements provides the opportunity to ensure a sustainable and durable market making service is implemented, something Mercury believes is not currently in place.

Key features the Authority should consider for implementation of a sustainable and durable market making service include:

1. There are a number of diverse participants with different forward views and different motivations to trade;
2. Trading is between parties who wish to and are willing to trade;
3. Market makers exist only to frame markets and ensure back-up liquidity;
4. A range of financial instruments are available to trade such as futures and options (as this leads to increased liquidity); and
5. Stringent information disclosure obligations are imposed on industry participants to minimise information asymmetry issues.

These features do not exist currently where market makers trade between each other for compliance reasons and there are few participants to ensure prices are robust.

The current market-making arrangements are not sustainable

As the consultation paper indicates since the market stress experienced due to gas outages in 2018 and 2019 the performance of market making in the futures hedge market has been under increasing scrutiny. The Government's Electricity Price Review recommended that regulation should be considered where an industry-led solution could not be implemented. Since this time, various market and regulator-led changes to the voluntary market making regime have been implemented. In December 2019 the Authority passed an urgent code amendment for a temporary mandatory market making provision due to concerns that market making may not be robust to potential market stresses anticipated in early 2020.

Mercury, while supportive of reform, has noted that continued regulation will not deliver least cost and sustainable market making outcomes. While market making outcomes have improved, the market has not experienced any of the stress present in late 2018 and throughout 2019. This includes over the first quarter of 2020 where considerable stress was anticipated due to concurrent outages on the HVDC link and Pohokura gas field. Throughout New Zealand's COVID-19 response demand has been suppressed, resulting in a significant and rapid fall in futures prices. In Mercury's view the current arrangements are not sustainable, and the market will function much more effectively if market makers are incentivised rather than forced to trade in the long-term.

Mercury supports a commercial approach to market making built on beneficiaries-pay

There are several reasons the existing arrangements may not be providing the best long-term outcomes for consumers, including:

- The current market makers are not necessarily the lowest cost providers of the market making service;
- The costs of market making are not currently allocated to beneficiaries. This results in a "free rider" problem where users demand increased services and market makers are not willing to improve or increase the level of services they provide;
- There are not enough mechanisms to allow market makers to manage risks associated with providing services; and
- There are insufficient incentives and penalties to deliver the appropriate level of market making service.

A commercial approach that addresses the above issues will have the greatest chance of delivering positive long-term benefits for consumers. While a commercial approach may take time to implement, Mercury suggests there can be a phased transition as ultimately a timely solution is less important than a durable long-lasting solution.

The outcomes of a commercial approach would result in the following:

1. More efficient levels of service due to beneficiaries facing proportionate costs of market making;
2. Increased liquidity due to a more diverse participants with different forward views and motivations to trade;
3. More effective risk management through the ability of market makers to transfer their rights to third parties; and
4. Increased durability of market making due to improved financial incentives to participate.

Mercury supports the Authority's view in the paper that "taking a beneficiary pays approach may lead to…entities advocating for an efficient level of service. The imposition of even a small charge to beneficiaries could potentially achieve this outcome."[1]

As part of its submission to the Hedge Markets Enhancements discussion paper in December 2019 Mercury advocated that a key element to a commercial approach is ensuring that all beneficiaries of market making services face at least some costs of providing the service. This will create a sustainable pool of funds to then incentivise market making participation from a more diverse set of participants.

Mercury is also of the view that a beneficiary-pays structure should apply to a mandated or regulated scheme should a commercial scheme not be progressed. Instituting and providing prior certainty of such a backstop structure would provide a greater incentive on stakeholders to assess the trade-offs between a commercial and mandated scheme and may result in beneficiaries being more willing to pay for enhanced services. Absent of such clarity, those who are currently free riding on the market making services (which are provided for free), will expect more of the same.

Mercury notes there was unanimous support for a beneficiary-pays structure in the proposal submitted to the EA in June 2020 by the Industry Working Group facilitated by Murray Nash. This group, whose members consisted of both current market makers and others, advocated for the introduction of a broad-based levy across both wholesale generators and purchasers. Mercury supports such a levy and recognises that it, along with other vertically integrated participants, would fund a higher portion of the cost (reflecting higher benefits) than merchant participants which is appropriate.

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Market Making specifications required to deliver sustainable outcomes

Mercury recommends the following design specifications should apply regardless of the type of scheme implemented (i.e. mandated or commercial):

- **Transferrable Obligations:** Market makers should have the right to contract out of and transfer rights to other market makers or third parties. This will encourage least cost market making and allow market makers much greater flexibility to manage risks;

- **Volume Obligations:** The current depth (12MW per contract) provided by market makers is sufficient and appropriate for the New Zealand market. This ensures there is 9MW per contract available for buying/selling for each market making participant (assuming 4 market makers) and 12MW for non-market makers. (If a mandated scheme is implemented then 11MW per contract (refer below) would also be sufficient);

- **Number of Market Makers:** Under a commercial scheme, the number of market makers should be determined by the least-cost solution to achieve a market depth of 12MW per contract. Under a mandated or regulated scheme, Mercury supports increasing the number of market makers to seven but with less onerous obligations on market makers. Our recommendation would be to require each of the current market makers (or their contracted alternate) to show two-way prices for 2MW per contract and the new entrants 1MW per contract. This would result in 11 MW being available to trade for non-market makers and 9MW for current market makers ensuring the current depth is maintained;

- **Consistent Spreads:** While volumes may vary, bid/offer spreads should be consistent. Spreads should be set at around five percent to reflect the market makers role of framing markets and providing a liquidity backstop. In Mercury's experience, this would reduce the cost of providing the service. We do not support a feature that allows for spreads to widen under stressed market conditions because it is during times of stress that participants need depth and liquidity to remain. We would however support a two-tier spread obligation where, for example, the long dated quarterly contracts are priced with a 3% spread and the monthly contracts (and each of the quarterly contracts that a monthly contract falls within) trade at a 5% spread. Mercury also does not support lower volume obligations in near term contracts compared with longer dated contracts as this structure could also increase the cost of providing the service as parties who build up positions in the longer dated contracts over time need the assurance there will be adequate depth in the market in the most volatile periods (i.e. near term) to manage exposure;

- **Appointment of market makers:** participation by potential market makers should be encouraged and particularly sought by financial institutions with experience in other electricity markets throughout the world. A current barrier for all current and potential new market makers is the asymmetry of information in the New Zealand market (Mercury has previously raised its concerns to the EA on matters such as thermal fuel availability and outage information). Resolving these issues is key to attracting more diverse participants to provide a market making service. With regards to the appointment of market makers, Mercury supports the process submitted to the EA in June 2020 by the industry group coordinated by Murray Nash.

Penalty provisions can be robust to drive behaviour

Mercury disagrees with the paper's assessment which suggests consequences for non-performance are neutral under a commercial arrangement. A commercial approach would ensure a high level of service availability as failure to do so would result in market markers forfeiting any incentive payments. A range of other measures could also be easily introduced including penalty payments that increase up to the price of procuring a new market maker in the event of non-performance. Any penalty payments could be returned to existing market makers to further strengthen participation. In this regard we suggest the structure outlined in the proposal submitted to the EA in June 2020 by the Industry Working Group facilitated by Murray Nash is a useful starting point for consideration.

Under a mandated/regulated scheme, where the payments to market makers are not established via a competitive process, and depending on the level of these payments, Mercury considers there must be provisions for market makers to be relieved of their market making obligations when they face legitimate portfolio stress. Mercury has advocated that a Director level sign-off requirement could be required in the event of non-compliance for market makers.

If a commercial approach is not viable, Mercury supports a modified mandatory scheme

If the Authority finds a commercial approach is not viable, or if a transitional step is required before a rules-based incentivised scheme is implemented, then Mercury recognises the Authority will need to implement a mandatory scheme. Under this scenario, Mercury strongly recommends the structure of such a scheme is consistent with the following principles:

- That the reasonable costs of providing market making are recovered from beneficiaries of market making, or if no cost recovery mechanism can be agreed upon, as a levy on all participants;
- A market maker may at any time contract away the delivery of market making services;
- The Authority must not "control" any aspect of a market maker's ability to contract;
- An effective measure and controls of fast market and portfolio stress is introduced; and
- Increasingly strong penalty incentives are implemented for non-performance of market makers (see comments in previous section)

Conclusion

Mercury welcomes the approach the Authority is taking to developing this workstream and we look forward to participating further in its development. Mercury agrees that a durable well-functioning futures market is integral to the long-term efficiency of the New Zealand electricity market. The most efficient arrangement, and the one which is most likely to be durable, is one in which participants pay for the level of service quality they demand. In Mercury's view a rules-based incentivised scheme is the most likely way of achieving these goals which are consistent with the Authority's statutory objectives.

If you have any questions on this submission please direct them to John Bright, Regulatory Strategist at john.bright@mercury.co.nz.

Yours sincerely,

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Appendix A. Mercury responses to specific issues

#	Question	Answer
1(a)	Has the Authority correctly described the approaches above? If not, please identify any changes to the approach description	Mercury broadly agrees with the description of the potential available approaches and provides further commentary in the cover letter to this submission.
1(b)	Are there any other approaches the Authority should consider? If so, please provide a brief description of the approach and its merits	Other than the suggested refinements as mentioned in our cover letter the approaches as outlined sufficiently capture the options. Mercury would agree with eliminating some of the lower scoring options (i.e. voluntary approaches) at this stage of the design process as they are unlikely to deliver sustainable outcomes in the longer term.
1(c)	Do you have strong preference or strong aversion to any of the approaches outlined? Please explain your reasoning	Mercury strongly favours a commercial approach. If a mandatory scheme is deemed necessary, we would need to see some refinements made before we could support it, as outlined in our cover letter. As above, Mercury is of the view the voluntary options can be eliminated at this point.
2(a)	Has the Authority correctly described the trade-offs above? If not, please identify any changes to the trade-offs	The descriptions are correctly described.
2(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	In addition to the key trade-offs covered in the paper the durability of each of the arrangements should also be considered. Depending on the type of market selected Mercury is also of the view that the scheme ought to include the specifications listed in our cover letter.
2(c)	What trade-offs are most valuable to you, and which are the least valuable to you, and why?	Refer to the discussion in our cover letter.
3(a)	Has the Authority correctly assessed each approach against the key trade-offs? If not, why not?	In Mercury's view the best possible outcome is a commercial arrangement, therefore we disagree with the overall evaluation which indicate that mandatory options are superior. As mentioned in our cover letter we disagree with the evaluation for consequences for non-performance in a commercial arrangement as "neutral" as there would be strong financial (or other) penalties for non-compliance. However, we accept that a mandatory back-stop may need to be considered and provide further comments on how this could be implemented to derive the greatest benefit in our cover letter.
3(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.	No comment.