

23 December 2024

Sarah Gillies
CEO
Electricity Authority
WELLINGTON

By email to: market.making@ea.govt.nz

Dear Sarah

Re: Consultation Paper – Market making – strengthening price discovery in the forward electricity markets

Introduction

I am writing to express concerns that Oji Fibre Solutions (OjiFS) has regarding the proposed changes to the duration of futures prices as traded on the ASX Energy exchange. This proposal to extend futures prices from three years to five years would both undermine competition in the electricity market and increase costs to consumers, with both outcomes going directly against the Authority's statutory objectives.

Background to Oji Fibre Solutions

OjiFS makes pulp and paper-based packaging products supplying NZ's agricultural and horticultural industries, with exports to a range of countries. We directly employ over 1,000 people in NZ, primarily in regional NZ, including Waikato and the Bay of Plenty. Renewable energy contributes over 80% of the Company's process heat requirements. OjiFS also uses approximately 500 GWh/annum of electricity and generates approximately 260 GWh/annum via biomass cogeneration.

OjiFS is a significant industrial user of electricity in New Zealand, and has multiple electricity contracts with various market participants.

OjiFS is a member of the Major Electricity Users Group (MEUG). OjiFS supports the submission made by MEUG on this consultation paper.

Concerns with market competitiveness

OjiFS is increasingly concerned about the competitiveness of the NZ electricity market, with spot market and secondary market electricity prices regularly exceeding what would be expected in a competitive market, and well above the levelised cost of energy (LCOE) for new generation projects. Elevated spot and secondary market prices are making it increasingly difficult to operate an energy intensive business, as illustrated by the closure of Winstone Pulp and the closure of both the Penrose recycled paper mill and the Kinleith paper mill.

While the intention to improve price discovery is admirable, we believe the current three-year forward curve already embeds excessive risk premiums, resulting in inefficient and inflated forward prices. Extending the contract horizon to five years would perpetuate these inefficiencies and further increase energy costs, with no evidence that longer-dated contracts would align hedge prices more closely with the long run marginal cost (LRMC) or the LCOE of new renewable generation. To make matters worse, Contracts-for differences (CFDa) offered to potential purchasers not only reflect the inflated risk premiums in ASX Futures prices, but also include further premiums above the ASX prices to reflect basis

risk, such as general market risk, locational price risk, that generator's operational risk, and perceived counterparty risk. This results in hedge prices exceeding a first-principles approach to market pricing¹ by a considerable margin.

We also seek clarification on which market participants have expressed interest in longer-term hedge contracts and whether this interest is representative of the broader market. This proposal will lead to higher contract prices for the periods covered by the ASX Futures market. As such, it is clearly in the interest of generators and will adversely affect OjIFS and other parties which would readily enter into contracts close to LCOE or LRMC. Indeed, with the increasing focus by the Authority on the hedging positions of large purchasers without a corresponding obligation on generators, the negotiating position of purchasers is already impeded by the Authority, which will only be exacerbated by this proposal.

A key concern that should be considered by the Authority is the continuing deindustrialisation of New Zealand. The Authority should not be implementing any changes to the Code (such as this) which will only serve to accelerate deindustrialisation. In our view the Authority should instead be focussing on mechanisms that will mitigate excessive risk premiums in forward contracts and increase competitiveness in the wholesale markets.

Responses to Consultation Questions

This submission is focused on the proposed changes to the duration of the futures price curve. Accordingly we have only responded to the relevant questions.

- Q10: We do not support extending the baseload futures horizon to five years. The current market structure and risk environment already challenge the efficiency of the futures market, and a longer horizon would exacerbate existing inefficiencies.
- Q11: OjIFS would not utilise longer-dated futures contracts, as current ASX futures already reflect inefficiencies and inflated risk premiums. Indeed, OjIFS would not enter into any contracts within the ASX pricing period given the considerable premium above LCOE or LRMC.
- Q12: While a reliable forward price curve could aid OTC negotiations, the presence of risk premiums embedded in the futures price undermines its value as a benchmark. It is clear that the forward price curve is not reliable, and therefore hard to see its value in negotiations. What occurs in reality is that the futures price becomes a minimum price offered by generators, making it increasingly difficult for large consumers to enter into contracts that reflect a fair market price such as something close to the LCOE or LRMC.
- Q13: The low trading volumes in longer-dated ASX futures reflect a lack of confidence in the market's efficiency. Reducing supply will not in any way increase confidence and would only serve to further increase forward prices.

Comments on the Infometrics Report

The Infometrics report² questions whether ASX futures are unbiased predictors of spot prices. While some bias dissipates in trades closer to expiry date, the report notes that ASX prices have not been efficient estimators of spot prices, particularly since 2018. This inefficiency is attributed to market structure and insufficient competition, as well as external factors such as hydro conditions and international events. Again, a first principles approach to spot market pricing provides a far better indication of long term pricing than the ASX Futures prices.

¹ See for instance the Energy Link forward price curves which are calculated on a first principles basis and are consistently lower and more accurate than futures prices.

² https://www.ea.govt.nz/documents/8617/Appendix_F_-_Infometrics_report.pdf

Authority's Statutory Objective

We note that the statutory objective of the Authority is “To promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.”

The proposed change to extend the ASX futures prices to five years is inconsistent with this statutory objective in three ways:

1. This proposal will not promote competition in the wholesale electricity (and consequently in the retail electricity) market. Indeed, as outlined previously, this will only act to reduce competition.
2. This proposed extension will only amplify the inefficiencies within the futures market.
3. This proposed extension will not act in the long term (or even short term) benefit of consumers.

Given that the proposed extension does not in any way support the Authority's statutory objective, and indeed is inconsistent with the statutory objective, it is difficult to see how the Authority could make a cogent argument to move forward with this proposal.

Concluding Comments

The New Zealand electricity market, dominated by four vertically integrated gentailers and a hydro-centric system, inherently carries elevated risk premiums. The marginal pricing model amplifies price distortions, while the ASX futures price exacerbates the market power of the four vertically integrated gentailers. The ASX future price is a particularly inefficient price discovery mechanism. Extending the ASX trading horizon would only serve to entrench inefficiencies and risk premiums. Addressing underlying market issues should be prioritized before considering any changes to the futures market. In particular, the Authority should be focused on mechanisms to mitigate excessive risk premiums in forward contracts and thereby increase competitiveness in the wholesale markets.

I would welcome the opportunity to discuss these concerns further if required. Feel free to contact me if you have any questions.

Yours sincerely

Darren Gilchrist
Energy Manager