

Meeting date: 19 September 2023



Findings from Investigation into Financial Transmission Rights (FTR) Market Conduct and Information Asymmetries

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1. Purpose

- 1.1. This paper seeks:
 - (a) to inform the Board of the findings from an investigation into market conduct on the FTR market – which indicates there is currently insufficient evidence to support intervention on conduct matters in the FTR market, and
 - (b) the Board's approval to publish a news item and market brief that notes the Authority's analysis on trading conduct in the FTR market.

2. Recommendations

- 2.1. It is recommended the Board:
 - (a) **note** the Authority published a decision paper: *Financial Transmission Rights Market Review* on 6 June 2023 which stated that:

'...the Authority will develop options for consultation that address potential regulatory issues regarding trading conduct on the FTR market and publish an issues paper for consultation mid-2023.'
 - (b) **note** that staff have further analysed FTR market trading behaviour and consider there is currently insufficient evidence to support intervention on conduct matters in the FTR market at this point in time.
 - (c) **agree** the Authority concludes the analysis of trading conduct in the FTR.
 - (d) **note** that the Authority will utilise the methodology used in this investigation to routinely identify instances of high-volume or high-priced FTR purchases and publish the analysis as part of the Authority's quarterly reviews.
 - (e) **agree** that the Authority notifies the market that the Authority will not be pursuing the regulation of trading conduct in the FTR market at this stage and briefly explain the reasons why, through a news item and accompanying market brief item.
 - (f) **note** that Staff will notify the following stakeholders of the Authority's decision prior to the public release of the news item and market brief:
 - (i) the Financial Markets Authority,
 - (ii) the Commerce Commission,
 - (iii) the System Operator,
 - (iv) the Grid Owner,
 - (v) the FTR manager.

3. Summary

The FTR market was established to enable greater competition for the benefit of consumers

- 3.1. The Authority established the FTR market in June 2013 to assist wholesale electricity market participants to manage locational price risk. The establishment of the FTR market was expected to benefit consumers by enabling greater competition in the wholesale and retail markets in alignment with the Authority's statutory objective (now the main statutory objective).
- 3.2. Since the inception of the FTR market, the market share of incumbent retailers has reduced, with independent retailers increasing market share (refer to **Appendix A**). This has resulted in a more competitive retail environment, to the benefit of consumers.
- 3.3. While there are other factors that have contributed to enhanced retail competition, the Authority has heard anecdotally from at least two retailers that FTRs had been a significant factor in enabling them to expand their retailing into new geographical areas.

Regulation of the FTR market was part of the Authority's wider review of the FTR market

- 3.4. In the May 2022 FTR issues paper¹, the Authority noted that:
 - (a) trading conduct in the FTR market (such as insider trading) is not regulated by the Authority, and
 - (b) the Financial Markets Authority – Te Mana Tatai Hokohoko (FMA) does not regulate insider trading in the FTR market given that the market is not a licensed market under the Financial Markets Conduct Act 2013 (FMC Act).
- 3.5. The Authority asked submitters to answer the question: *"do you think there is a requirement for enhanced oversight of the FTR market?"*. With misconduct issues in the FTR market not explicitly regulated by either the FMA or the Authority, and only broadly covered by various other pieces of New Zealand legislation,² the Authority observed in the issues paper that regulatory oversight of the FTR market could be improved.
- 3.6. The Authority received limited feedback on this question. Three submitters agreed with the assertion that regulatory oversight could be improved, and three disagreed. A common theme among submitters, however, was that regulation of the FTR market should be improved only if there was a need to do so and that excess regulation of the FTR market would likely increase barriers to entry for participants.

Staff investigated whether there was a need for further regulation of the FTR market

- 3.7. Staff investigated whether any specific evidence of misconduct or harm in the FTR market could be observed, to determine if further action was required. This investigation was progressed separate to the FTR review which concluded with the publication of a decision paper in June 2023, stating:

'...the Authority will develop options for consultation that address potential regulatory issues regarding trading conduct on the FTR market and publish an issues paper for consultation mid-2023.'

¹ <https://www.ea.govt.nz/projects/all/ftr/consultation/ensuring-arrangements-are-fit-for-purpose/>

² Namely the Financial Markets Conduct Act 2013 and the Commerce Act 1986.

- 3.8. As part of this investigation, staff explored:
- (a) the specific regulation of the conduct of participants on the FTR market to understand whether the legislation that does apply to the FTR market is fit for purpose to deter these behaviours, and
 - (b) whether there were any instances of poor conduct that could be observed through retrospective analysis, that might illustrate the extent poor trading conduct was occurring on the FTR market.
- 3.9. Staff investigated the regulation of the FTR market through an analysis of applicable New Zealand legislation in consultation with other New Zealand regulators, the system operator, the grid owner, and the FTR manager. Staff also conducted an analysis of FTR bidding data to determine the extent to which poor trading conduct might be occurring on the FTR market.

Conclusions of this analysis indicate that trading misconduct is not occurring on the FTR market and the risk of information asymmetries arising is low

- 3.10. In summary, staff could not identify any FTR trades that indicated trading misconduct had occurred in the past eight years of the market. Furthermore, through conversations with the system operator and grid owner, staff concluded that the existing structures and processes in place significantly mitigate the risk of information asymmetries occurring. Accordingly, staff are satisfied that the risk of trading misconduct occurring on the FTR market is low.
- 3.11. This paper sets out the findings from this analysis, as well as Authority staff's conclusions and recommended forward actions. The recommended actions reflect the relative risk of harm occurring and sets out several avenues to address the perceived regulatory gap in future. This paper also sets out a communications plan for notifying industry and other stakeholders of the change in direction for this work programme.

4. Staff investigated whether there is a potential gap in the regulation of the FTR market

- 4.1. Authority staff initiated a review of the regulation of the FTRs as part of its wider investigation into the FTR market.

The nature of the FTR market participants increases the risk of information asymmetries being used for financial gain

- 4.2. In the FTR market, the participation of both physical and non-physical participants increases the risk of some purchasers of FTRs being aware of information that is not otherwise known by other participants on the FTR market – referred to as “information asymmetries”.
- 4.3. Asymmetric information refers to when one party in a transaction holds more information than the other. In many cases growing asymmetrical information indicates a healthy market economy where certain participants become increasingly specialised and productive.
- 4.4. However, information asymmetry can lead to market inefficiencies through adverse selection – a situation where sellers have information that buyers do not have (or vice versa) about some aspect of product quality.

Existing regulation broadly addresses trading conduct on the FTR market

- 4.5. When the FTR market was implemented, it was designed to have a reduced regulatory burden on participants to actively encourage participation on the market. Regulation of the FTR market spans several pieces of New Zealand legislation, and there are currently several regulatory regimes that may provide some degree of regulatory oversight of the FTR market.

- 4.6. While these various regulatory regimes cover different aspects of the FTR market in different capacities, in practice there is not a specific regulatory regime designed to enforce trading conduct requirements on FTR participants. While the active management of the FTR market is governed by the Code (and undertaken by the FTR Manager on behalf of the Authority), some aspects of conduct on the FTR market are covered by other regimes.
- 4.7. A more detailed analysis of the regulatory regimes that apply to the FTR market - and how they potentially address trading conduct by FTR participants - is discussed further in **Appendix B**.

Insider trading in the FTR market is not specifically regulated by the Code or existing regulation

- 4.8. As noted above, there are currently several regulatory regimes (overseen by various New Zealand regulators) that deter unwanted practices or behaviours in the FTR market. However, their effectiveness for preventing insider trading in the FTR market appears to be limited as many of these regimes were not designed specifically for regulating trading conduct (such as insider trading) in the FTR market, and therefore may not be fit for purpose.
- 4.9. Further, the capacity of regulators to actively regulate the FTR market may be limited given the disparate strategic priorities and resource allocations across different organisations.
- 4.10. The conclusion from the above is that trading conduct in the FTR market may not be sufficiently regulated by the Authority or any other regulator. Rather, instances of trading misconduct are typically investigated ad-hoc as part of a regulators' complaints process. Accordingly, the Authority observed that the regulation of the FTR market could be improved and expressed concern that there may be a regulatory gap on the FTR market.

5. The Authority did not identify any evidence to suggest this lack of clear regulation was of significant concern

- 5.1. To conclude if further action was required, staff sought to determine the extent that an unclear series of regulatory regimes was an issue of concern. Specifically, staff investigated whether insider trading had occurred on the FTR market in the past, and whether the existing structures or processes in place might address the risk of informational asymmetries that could lead to the occurrence of trading misconduct.
- 5.2. Authority staff conducted an analysis on the following:
 - (a) FTR auction bid data to determine the extent to which poor trading conduct might be occurring on the FTR market, and
 - (b) the processes through which the system operator and grid owner communicate grid outages and constraints to FTR participants to determine whether some participants might have access to information prior to others.
- 5.3. Detailed descriptions of these analyses are attached at **Appendices C and D** respectively.

Staff did not find any FTR trades that raised concern

- 5.4. An investigation of FTR trades from the last eight years did not reveal instances of high-volume or high-price trades that could not be explained by market conditions at the time of the FTR auction.
- 5.5. Staff analysed the distribution of contract prices and volumes traded for each FTR path over the past eight years of data. Contracts awarded at unusually high prices and volumes were identified as being the focus of further investigation.
- 5.6. Where the high-than-usual prices and volumes identified could not be explained by market conditions, staff investigated whether these changes in bidding patterns coincided with

market conditions. If so, staff explored whether those participants could potentially have had access to information about that circumstance prior to others and traded upon it.

- 5.7. Staff also consulted with the FTR manager about this issue. The FTR manager could not identify any instances where FTR trades have raised concern.
- 5.8. The results of the analysis of FTR bidding data did not indicate any circumstances that indicated insider information was being utilised. Consequently, staff do not consider there to be any evidence that trading misconduct (utilising insider information or information asymmetries) is occurring on the FTR market.

Staff also identified several processes and public resources that mitigate the risk of trading misconduct occurring in future

- 5.9. The Authority also considered the processes by which Transpower (as both the system operator and the grid owner) interact with participants, to assess the risk that information is provided to a participant exclusively. Consideration was given to both the outage planning processes and the real time coordination processes.
- 5.10. Discussions were had with Transpower staff to understand, for example:
 - (a) whether a generator could conceivably be able to withhold knowledge of an outage before purchasing FTRs commensurate with that outage, or
 - (b) whether a physical participant could be informed of a grid constraint before other participants through the system operator contacting them as part of real time coordination.
- 5.11. Staff concluded that there are comprehensive processes governing both the outage planning process and the processes governing real time communications with participants. These processes are designed to prevent certain participants from gaining exclusive information that could be traded upon for profit on the FTR market.
- 5.12. There are also several resources available to participants to obtain information about the status of various generation assets or be made aware of grid constraints or outages. These resources, many of which Transpower provides, are universally accessible.

6. Staff are satisfied that there are adequate measures to mitigate the risk of trading misconduct on the FTR market

- 6.1. While a potential issue of a gap in the regulation of the FTR market remains, the system operator has several processes in place to mitigate the risk of a situation arising where this gap could be utilised by participants. Specifically, the outage planning and grid emergency processes allow for participants to obtain information readily and quickly about the status of the grid.
- 6.2. Given the availability of information to participants, and the time constraints of FTR auctions, the risk that participants can effectively trade upon inside information for financial gain on the FTR market is low.
- 6.3. Furthermore, creating additional regulation to the FTR market may have the following effects:
 - (a) It may give rise to the suspicion that misconduct has been occurring on the FTR market, when there is no evidence that it has, which may undermine confidence in the market.
 - (b) It would divert Authority resources away from other higher-priority work programmes, and the marginal benefit of committing resources to this project are unclear.

Staff recommend that the investigation into FTR market regulation be concluded

- 6.4. Staff believe that the evidence base is not sufficient for further action at this time. There will be opportunities for the Authority to address the perceived regulatory gap as part of broader work programmes in future. This is discussed further below.

The Authority will continue to monitor the FTR market for any trading behaviour that might cause concern

- 6.5. The Authority will routinely utilise the methodology used for this analysis to identify instances of high volume or high priced FTR purchases every six months. Should an FTR trade cause concern, the Authority can investigate for potential issues of trading misconduct. Maintaining a monitoring presence of FTR trades ensures the Authority can identify instances of trading misconduct should it occur in future.

7. There may be opportunities to address the potential regulatory gap in the future

- 7.1. Although staff do not believe there is currently sufficient justification for the Authority to address the potential regulatory gap as its own work programme, the issue of a gap in the regulation of trading conduct on the FTR market remains.
- 7.2. Pursuing a bespoke regulatory regime that specifically imposed trading conduct requirements on FTR participants would likely be a resource-intensive process. Further, increased regulation of FTR participants could potentially increase the compliance costs for participation on the FTR market, which may have adverse effects on participation which in turn may ultimately result in poorer outcomes for consumers.
- 7.3. Given the lack of evidence of trading misconduct occurring, and the existence of several mitigating factors against the risk of it occurring in future, the marginal benefits of pursuing further regulation are unclear. Rather than commit resources to addressing this potential issue immediately, there are upcoming opportunities where the Authority might address this issue as part of other Authority work programmes – discussed below.
- 7.4. In any instance where the regulation of the FTR market is addressed in future, Authority staff will work closely with other regulators to ensure any proposed options are well-considered, robust, and address any issues of overlap with other agencies' roles and statutory objectives.

MDAG recommendation: extend trading conduct rules for hedge and contract markets

- 7.5. The Market Development Advisory Group's options paper *Price Discovery in a Renewables-based Electricity System*³ includes an option to extend trading conduct rules for hedge markets. The MDAG suggested there is merit in extending the coverage of trading conduct rules to the contracts market, and that this should help address competition concerns. The MDAG will be further considering this proposal as part of its final recommendations to the Authority – due to be published December 2023.
- 7.6. Should the Authority choose to accept this recommendation, the Authority will ensure the resulting workstream considers the analysis within this paper and considers extending the trading conduct rules to the FTR market as well.
- 7.7. However, Staff note that the trading conduct rule as it is currently written is specific to the spot and ancillary services markets. A significant amount of resource would be required to develop a fit-for-purpose regime that applies to hedge and contracts markets.

³ Published December 2022

Centralised location for non-outage information disclosure

- 7.8. A centralised location for non-outage information disclosure is a recommendation of both the wholesale market review and the post-implementation review of wholesale market information disclosure obligations.
- 7.9. These reviews suggest it would be easier and more convenient – and potentially reduce information asymmetry for market participants – if there was a centralised location for non-outage information disclosure. While there appears to be sufficient avenues for participants to make their various types of information publicly available, the absence of a centralised form of notification (such as POCP for outages) means that some information can go unnoticed. This can create some forms of information asymmetry despite participants fulfilling their public disclosure obligations.
- 7.10. If the Authority decided to implement these recommendations, the analysis in this paper could be noted to ensure that the information asymmetries between FTR participants is considered as part of the design of a centralised information disclosure platform.

8. Next steps

The Authority will need to communicate this conclusion with the industry

- 8.1. As the Authority indicated it would release an issues paper discussing this issue in the June FTR decision paper, the Authority will need to give notice of the conclusion of this work to the industry and other stakeholders.
- 8.2. These communications will inform the market that the Authority has not found substantive evidence of harm to support the release of an options paper at this time. They will also note that the Authority will continue to monitor the FTR market and may consider consulting on options if evidence of misconduct occurs.
- 8.3. Staff recommend that the Authority notifies the market via a market brief item and accompanying news item, outlining the Authority's decision to not pursue this investigation at this point in time. Staff believe that a news item is the most suitable vehicle for signalling to the industry a formal notification of changes to the direction of a work programme.
- 8.4. Staff do not expect any significant reaction or feedback from stakeholders as a result of this decision. Only six submitters provided feedback on the issue of FTR market regulation (with only three submitting there was a potential issue), and the highly specialised and niche nature of the market means there are only a small number of concerned parties.
- 8.5. Staff will develop a communications plan to notify the industry of this change. This includes:
 - (a) Outlining key messages.
 - (b) Identifying risks and creating messaging to mitigate these in case of any stakeholder or media interest.
 - (c) Emailing submitters to the FTR review with a notification of the state of the work
 - (d) Creating a market brief item to notify submitters, stakeholders and wider industry that the FTR conduct investigation is concluding for now – with outlined reasoning and evidence.
 - (e) Publishing the accompanying news item on the FTR project page and on the Authority's website, publishing a news item and a market brief item which will go out to industry newsletter subscribers.

The Authority will conduct further analysis on the FTR market's funding and design in future

- 8.6. The Authority noted in its June 2022 decision paper titled *Financial transmission rights Market Review* that:

"There are further lines of enquiry with respect to market funding and design options for the FTR market that have been identified and can be followed..."

In addition to other priorities across its entire policy function, the Authority will also consider the upcoming final recommendations from the Market Development Advisory Group on 'Price discovery in a renewables-based electricity system' before committing to a further review on the design of the FTR market".

- 8.7. The Authority will conduct further analysis to determine whether the FTR market is operating for the long-term benefit of consumers. Should the Authority consider changes to the design of the FTR market, consideration of trading conduct rules will form a part of that analysis.

9. Funding

- 9.1. This paper does not have any funding implications.

10. Attachments

- 10.1. The following appendices are attached to this paper:

- Appendix B Analysis of regulatory regimes that apply to the FTR market
- Appendix C Analysis of FTR bidding data
- Appendix D Investigation of processes for sharing grid status information