29 March 2022

Electricity Authority
Level 7, ASB Bank Tower
2 Hunter Street
Wellington

To whom it may concern,

Re: Hedge Market Enhancements: Commercial Market Making Scheme Code Amendment

The Electricity Authority ('Authority') is seeking to improve the performance and reliability of market making services in New Zealand electricity futures contracts by introducing a commercial market making scheme.

Contact is supportive of the move towards a fully commercial market making scheme. We believe the fully commercial scheme will deliver the most efficient market making outcome for New Zealand electricity market participants and consumers.

Contact holds some concerns that aspects of the Authority's proposals for the commercial market making scheme will deliver lower benefits than have been described in the consultation document. However, given the nature of the qualitative benefits it is difficult to determine how detrimental this is to the consultation recommendations.

1. Volume and alignment of code with commercial scheme

Contact supports a total of 12 MW of volume in each contract and we agree that the code should align with the commercial market making scheme.

2. Bid-ask spread

As noted in previous consultation responses, Contact believes the bid-ask spread at 3% is too narrow for contracts at the front end of the future curve given the underlying high volatility in the New Zealand wholesale electricity market.

An alternative hybrid option could have wider bid-ask spreads in the front four quarters and monthly contracts, and lower bid-ask spreads in the remaining quarterly contracts.

We do acknowledge wider spreads have a cost trade-off for non-market making participants looking to trade in the market making window, but there may be benefits from a reduction in instantaneous trades.

3. Exemption change

Contact understands the rationale behind the changes to a 20 trading day moving average for exemption days.

3.1 Market making behaviours under the current scheme

We would expect market makers to be willing to continue providing the market making service in a product where those services had low costs. The use of all exemption days in a month under the current scheme reflects the significant costs associated with being a market maker.

The result of market makers concentrating liquidity at the start of the month could be a strategy to minimise the chance of having the back-up market making Code provisions applied.

Saving exemptions to the end of a month can also cover unexpected circumstances such as third party trading software issues[1] and illness.

3.2 Increased staffing requirement

Whilst we agree there is some benefit in avoiding the gaps in market making that happen at the end of each month, the proposed change will result in an increase in our staffing requirements to ensure that the new terms can be met.

3.3 Third party issues causing breach of five day rule

Under the proposal market makers will be more incentivised to spread out their use of exemption days.

In the event that an issue arises that is not a permitted circumstance, and it prevents the market maker from meeting the terms of the agreement, there is likely to be less time to resolve the issue before the five day rule is breached. Contact believes an additional permitted circumstance should be allowed where an event can be proven to have been caused by a third party and is out of the market makers control.

An example of this could include a software issue with the market makers trading software, or inadvertent changes to risk parameters made by the market makers clearing broker.

4 Refresh obligation

4.1 Bid-ask spread the largest contributor to instantaneous trades

Contact has consistently argued that market makers should frame the market. We believe the issue of instantaneous trades at the start of the market making window is primarily driven by the low bid-ask spread.

The combination of the low bid-ask spread and underlying wholesale market volatility incentivises market makers to enter their orders in the market making window at the last possible moment. It should be no surprise that, with the front end of the curve being the most volatile[2], it records the most instantaneous trades.

While the refresh obligation may help somewhat, we think it's unlikely that the loss of volume issue will be fully resolved if a 3% bid-ask spread is retained.

Contact can understand why market makers would tender a lower price for a scheme with a refresh obligation, as it offers a chance for them to manage their own risk. [ ]

[1] Third party software issues are not covered as a permitted circumstance.
[2] Front end contracts have a higher correlation with wholesale market spot price movements.

Contact believes a scheme with wider spreads in the front end of the futures curve and lower spreads at the back end has merit. A refresh obligation could also be incorporated into this scheme.

4.2 Design of volume obligation creates the possibility to trade more than 24 lots

Appendix E of the consultation shows the design of the volume obligations can result in market maker with a 24 lot volume obligation may end up trading anywhere between 24 and 35 lots before their obligation is fulfilled due to only being able to adjust bid and ask volumes at the point of the refresh obligation[3].

We believe this creates an inconsistency between the total required maximum volume[4] and clause 13.236L(3)[5]. This inconsistency may lead to an increase in market makers trading and clearing costs when compared against expectations of trading a maximum of 24 lots per contract.

We can see how the proposed amendment may make sense in a market with low volatility, however, in volatile market conditions where prices move significantly within a market making session this may result in an increase in realised losses in a market making session.

Contact favours market makers being able to adjust both bid and ask volumes constantly based on the overall traded volume - as is allowed under the current market making scheme. This concept could be introduced alongside a volume refresh at the point in which the market maker has traded 12 lots in total[6].

4.3 Compliance complexity and measurement costs

The refresh obligation will make it more difficult for the ASX and the Authority to determine whether a participant has complied with its market making obligations. We are concerned that the Authority appears not to have scoped the development costs for ASX and itself to measure the compliance with the new scheme prior to determining net benefits in this consultation.

4.4 Real-time compliance

The refresh obligation will increase the risk of a technical failure on the part of the market maker due to the increased complexity, and it will be significantly more difficult for a market maker to assess its compliance with the market making obligations in real-time. Measuring real-time compliance under the proposed scheme may require the development of a real-time compliance module at an additional cost to the market maker.

In the event the Authority chooses to go ahead with the proposed refresh requirement, we recommend either a period of testing the new scheme settings or a period of grace to allow market makers and those measuring compliance to test their systems and adjust them accordingly.

4.5 Development costs and lead times

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[3] An example is outlined in Appendix 1.
[4] 24 lots (or 2.4 MW)
[5] The inability to change bid or ask volumes until either the point of refresh or the total traded volume has been met.
[6] An example is outlined in Appendix 2.

The Authority should note that there are significant development costs and lead times associated with preparing for these changes for market makers. Given that there appears to be the possibility of further changes to the proposed scheme following this consultation, we suggest that any proposed scheme should not be implemented until at least three months from the point at which the Authority confirms the final settings of the commercial market making scheme.

5. Cost Benefit Analysis

5.1 Exemption change

In Table 1 of the cost benefit analysis, the analysis ignores the additional resourcing costs faced by market makers to ensure the are compliant with the commercial market making terms. We believe the additional costs across market makers would exceed $500,000 per annum in the event they are required to increase staffing levels to meet their market making activities.

5.2 Refresh obligation

Contact believes the primary driver of the liquidity issue that the Authority seeks to improve is a low bid-ask spread. With the introduction of the refresh, the number of inadvertent trades is unlikely to change, but the volumes associated with those trades will be lower. [ ]

Given the complexity of the changes, we expect iterative changes will be required to trading systems rather than a one-off change. As market makers gain experience in the proposed commercial scheme, they will likely seek to improve the performance of their trading systems which will involve further development costs. We expect our initial development costs to be in the region of [ ], with any further iterations adding to this amount.

5.3 Bid-ask spread

We note that the Authority has not attempted to value widening the bid-ask spread as a way of reducing inadvertent trades and reducing the overall cost of market making services. We acknowledge that a wider spread would have additional costs on those seeking to participate in the market making session but given the lack of liquidity caused by a large percentage of inadvertent market maker to market maker trades, we suspect this cost may not be as high imagined when the benefit of the increased liquidity to non-market makers is accounted for.

6. Code drafting suggestions

6.1 Clause 13.236L(4)

We believe the reference should be 13.236L(2)(b).

6.2 Clause 13.236N(a)

We believe an additional reason (i.e. 13.236N(a)(iii)) should be added to cover situations where the market maker is affected by third party issues that are out of its control[7]. The onus should be on the participant to prove to the Authority that the third party issue is affecting its ability to meet clause 13.236L.

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[7] These may include trading software issues or inadvertent changes to risk settings by clearing broker which prevent the market maker from trading.

We believe this type of clause should be included in the market makers agreement with ASX.

If there is anything in our response that you wish to discuss further, please feel free to contact me.

Yours sincerely,

Nigel East
Forward Markets Manager

Appendix 1: 35 lot trading example

Trade 1: Bid trades 12 lots.
Trade 2: Bid trades 11 lots
Trade 3: Ask trades 12 lots

The refresh obligation is highlighted yellow.

	Bid Volume	Ask Volume	Bid Trade Volume	Ask Traded Volume	Total Buys	Total Sells	Total Traded Volume
Initial	12	12			0	0	0
Trade 1			12				
After Trade 1	12	12			12	0	12
Trade 2			11				
After Trade 2	1	12			23	0	23
Trade 3				12			
After Trade 3	0	0			23	12	35

Appendix 2: Preferred approach to refresh and quantity adjustments.

Trade 1: Bid trades 5 lots.
Trade 2: Bid trades 7 lots
Trade 3: Ask trades 5 lots
Trade 4: Bid trades 5 lots.
Trade 5: Bid trades 2 lots

The refresh obligation is highlighted yellow.

	Bid Volume	Ask Volume	Bid Trade Volume	Ask Traded Volume	Total Buys	Total Sells	Total Traded Volume
Initial	12	12			0	0	0
Trade 1			5				
After Trade 1	7	7			5	0	5
Trade 2			7				
After Trade 2	12	12			12	0	12
Trade 3				5			
After Trade 3	7	7			12	5	17
Trade 4			5				
After Trade 4	2	2			17	5	22
Trade 5			2				
After Trade 5	0	0			19	5	24