16 June 2020

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

To whom it may concern,

Re: Hedge Market Enhancements Market Making Consultation Paper

The Electricity Authority ('Authority') is seeking ways to improve the confidence and reliability in the exchange traded market for New Zealand electricity contracts. The Authority notes that, whilst the voluntary market making arrangements have worked well for the majority of the time, there are concerns that the arrangements do not deliver the required service levels during market stress.

Contact has, for some time, held the belief that the voluntary market making arrangements are unsustainable, however, we view the futures market as being of significant value to the New Zealand electricity market, and support its sustainable development.

We firmly believe the most efficient outcome to deliver the required confidence and reliability, is a fully commercial market making solution, where the beneficiaries of market making contribute towards a scheme in which market makers are paid for the services they provide.

We set out our position on future market making development against the Authority's assessment in the following sections.

We also outline a high level assessment of the direct and indirect costs of being a market maker in Appendix A, and note our participation in the industry-led forum on incentivised market making in Appendix B.

Regards

Nigel East
Forward Markets Manager

Assessment of Trade-Offs

The Authority is seeking feedback on the trade-offs of the six different approaches that it could take with regard to market making. The five trade-offs are listed as:

(a) adjusting the number of market makers;
(b) increasing the diversity of market makers;
(c) involving markets in the design of market making;
(d) allocation of the costs of market making; and,
(e) the consequences of non-performance

We have ranked and weighted the effectiveness of the trade-offs in order of importance to achieving the goal of improving reliability and confidence in market making.

Rank	Trade-off	Weighting	Comment
1	Allocating the costs of market making	30%	Allocation of costs is the key to unlocking all potential avenues to improve the confidence in and reliability via a sustainable market making service. It allows the most potential for increasing both the number of market makers, and diversity of market makers. It justifies commercial consequences for non-performance, and that all participants are engaged in the process of setting an appropriate market making scheme. Knowing costs allows changes in levels of service to be balanced by benefits, to provide an effective and efficient market. We believe the best way to discover the costs of market making is via a competitive tender.
2	Adjusting the number of market makers	25%	Increasing the number of market makers will allow for the improved sharing of risk, increasing liquidity and reducing the cost to each market maker of participating in the market. Increasing the number of market makers will naturally lead to a smaller bid-ask spread. It should be noted that market making comes with a number of significant fixed costs, and mandating market making will increase the

Rank	Trade-off	Weighting	Comment
			costs on newly mandated parties. These costs may be more efficiently met by another more experienced party.
3	Increasing the diversity of market makers	20%	Increasing the diversity of market making participants will improve the resilience of market making services during times of stress. Experienced market makers may also add additional liquidity in products outside of the market making agreements. The addition, the differing points of view will improve the efficiency of prices.
4	Consequences for non-performance	15%	Designing appropriate commercial consequences for non-performance may lend more weight to non-performance penalties than can be given under the Code. The appropriate reliability of market making can be set by toggling the level of any penalty. Commercial consequences, if designed well, would avoid the need for Code breach investigations and extensive over-head costs of administering a mandatory scheme.
5	Involving markets in the design of market making	10%	Involving markets in the design of market making allows the Authority to determine the most efficient settings for market making, especially under a fully commercial arrangement.

Additional Trade-Off Criteria

Contact believes the Authority should also acknowledge the administration cost of each market making scheme. The mandatory approaches are likely require significantly higher administration costs than the commercial alternatives.

Evaluating the market making approaches and trade-offs

The Authority has evaluated the differing approaches it could take with regard to market making, and assessed each against the five key trade-offs in its ability to improve the confidence in and reliability of market making. Below, we present our view on the Authority's assessment and make comment where our assessment differs from that of the Authority.

The Voluntary Approach

Trade-Off	Authority	Contact	Comment
Adjusting the number of market makers	××	××	
Increasing the diversity of market makers	××	××	
Involve markets in the design of market making	-	-	
Allocate the cost of market making	×	×	
Consequences of non-performance	××	××	

The Voluntary Approach with Mandatory Backstop

Trade-Off	Authority	Contact	Comment
Adjusting the number of market makers	✓	✓	
Increasing the diversity of market makers	××	××	
Involve markets in the design of market making	×	×	
Allocate the cost of market making	✓	×	The costs associated with market making have not been discovered by a competitive process. The Authority may be over or under collecting if it collects and allocates levy payments.
Consequences of non-performance	✓	✓	

The Commercial Approach

Trade-Off	Authority	Contact	Comment
Adjusting the number of market makers	-	✓✓	Adjusting the number of market makers can be achieved by paying for more market makers. This is consistent with the Authority's assessment of increasing diversity by paying more.
Increasing the diversity of market makers	✓✓	✓✓	
Involve markets in the design of market making	✓✓	✓✓	
Allocate the cost of market making	✓✓	✓✓	
Consequences of non-performance	-	✓✓	Penalties for non-performance could be designed in such a way that they were more significant than a Code breach.

The Mandatory Commercial Approach

Trade-Off	Authority	Contact	Comment
Adjusting the number of market makers	✓✓	✓✓	
Increasing the diversity of market makers	✓✓	✓✓	
Involve markets in the design of market making	✓	-	The costs of market making by mandated parties are not accurately discovered. The most efficient providers of market making services may not be chosen.
Allocate the cost of market making	✓	-	Costs of mandated parties are internalised, and lead to an inefficient outcome.
Consequences of non-performance	✓	✓	

The Mandatory Approach with Transferable Providers

Trade-Off	Authority	Contact	Comment
Adjusting the number of market makers	✓✓	✓✓	
Increasing the diversity of market makers	✓	✓	
Involve markets in the design of market making	✓	✓	
Allocate the cost of market making	✓	-	Price data from obligated parties will likely be the outcome of an uncompetitive tender or negotiation.
Consequences of non-performance	✓	✓	

The Mandatory Approach

Trade-Off	Authority	Contact	Comment
Adjusting the number of market makers	✓✓	✓✓	
Increasing the diversity of market makers	××	××	
Involve markets in the design of market making	××	××	
Allocate the cost of market making	✓	×	The costs of market making have not been discovered by a competitive tender process.
Consequences of non-performance	✓✓	✓✓	

Ranking the different approaches

Applying our view on the weightings of the trade-offs against the various approaches[1], we come to the conclusion that the commercial approach has the most potential to meet the goal of improving the reliability of and confidence in the futures market.

We recommend the Authority progress the full commercial approach to the cost benefit analysis stage.

Rank	Authority	Contact
1	Mandatory-Commercial	Commercial
2	Commercial	Mandatory-Commercial
3	Mandatory with transferable providers	Mandatory with transferable providers
4	Mandatory	Mandatory
5	Voluntary with backstop	Voluntary with backstop
6	Voluntary	Voluntary

[1] The following values were applied to our ranking of the alternatives ✓✓ = 2, ✓ = 1, - = 0, × = -1, and ×× = -2.

Appendix A

The costs of being a market maker

Below we describe our assessment of the costs of being a market maker. There are direct costs and indirect costs associated with being a market maker. The direct costs are relatively straight-forward, however, indirect costs are more difficult to assess.

Direct Costs

Full Time Equivalent (FTE) Trading Staff

To meet the current market making agreement, the required FTE is 4.

Full Time Equivalent (FTE) Back-Office Staff

To meet the current market making agreement, the required FTE is 1.

Trading Software Fees

To undertake market making, most market makers will use a software package such as Trading Technologies TT platform. Charges may be based on a fixed monthly amount per login, or on trading volumes.

Deal Capture Software Fee

Software that automates deal capture from ASX trades is based on an annual fee.

ASX Fees

ASX trading fees range from $17 per MW for Monthly futures to $25 per MW for Quarterly futures[2].

Clearing Fees

Clearing fees are additional to ASX fees. The charges are agreed between the participant and clearer.

Broker Fees

Brokered transactions also attract brokerage fees. The charges are agreed between the broker and the client.

Margin Requirements

Open ASX positions require the posting of initial and variation margins[3]. The most common form of meeting margin calls is cash (although other instruments are accepted). Market makers are required to fund these margin calls off their own balance sheets, and forego using the funds to support other investment.

[2] Market makers currently receive a partial rebate on exchange fees for trades completed in the market making window.
[3] See https://www.asx.com.au/data/clearing/ASX_Energy_Margin_Parameters.pdf

Realised Profit and Loss

Market makers may realise a profit or loss on transactions that get closed out. This profit or loss can have a significant financial impact on the market maker.

Indirect Costs

Indirect costs are somewhat harder to measure. We describe some indirect costs in the case where a market maker chooses to manage risk from market making with their generation portfolio.

Backing ASX market making transactions from a generation portfolio

Some market makers that also hold generation assets may choose to manage the risks associated with a market making position with their generation portfolio.

The indirect costs may result:

- Reserving generation capacity to cover short futures positions by reducing sales through other channels (i.e. physical or over-the-counter financial channels). This cost could be significant depending on the marginal cost of supply versus the futures price. If the short positions do not materialise, the market maker has missed out on potential sales revenue and will not make a return on the generation assets.
- The market maker may end up being a net purchaser of futures trades at costs greater than their own fuel costs.

Appendix B

Industry-led forum on incentivised market making

Contact notes that it was a participant in the industry-led market making forum. Contact is supportive of the proposal, and recommends that the Authority makes use of the findings, should it proceed with the full commercial option to the cost benefit analysis stage.