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16 June 2020

Submissions
Electricity Authority
Wellington

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RE: Hedge Market Enhancements Market Making – ensuring market making arrangements are fit-for-purpose over time, consultation paper.

Thank you for the opportunity to comment on the proposals for enhanced market making. This paper together with the November 2019 discussion paper has assisted with understanding workings and constraints with the futures market as part of wider hedge strategies. Importantly it advances specifics as to how the market may be improved.

NZ Steel supports actions that with build a robust and efficient market. However, we are concerned the Authority has failed to appreciate just how little confidence NZ Steel as a major market participant, and no doubt others, have in the current mechanisms. Paragraphs 1.7, 1.8 and 5.5[1] record lack of stakeholder confidence in market making and price formation on the ASX market. We have previously advised the Authority of a lack of confidence in the effectiveness and operation of the wider NZ hedge market. On occasions, such as late 2018 early 2019, NZ Steel has considered the whole market could best be described as dysfunctional. Additionally, we note over this period NZ electricity has moved to be noticeably more expensive than overseas steel manufacturing jurisdictions our parent company is involved in.

While we understand the focus of those involved with market making enhancement, the Authority Board need to ask the question, is the market as successful as you think, and does it provide a sufficient base from which to enhance market making? The wholesale market has not delivered what we expect as a large consumer. The question needs to be asked, has the NZ futures market failed (along with most other attempts around the world[2]) or at least failed to meet the needs of some consumers? As outlined in the 2019 paper, it has certainty faltered from time to time[3].

In developing market making mechanisms it is important to understand and communicate the reason intervention is required to force market making. Arguably this could relate to the decisions taken in the late 1990s to allow vertical integration of the four large generator / retailers. This was a considered decision at the time and may well still be the best structure for NZ. However, there are

[1] https://www.ea.govt.nz/dmsdocument/26664-hme-market-making-consultation-paper
[2] Footnote 5 page 4, https://www.ea.govt.nz/dmsdocument/26019-hedge-market-enhancements-discussion-paper
[3] Para 3.1, page 5, ibid.

significant implications to the markets that currently operate. This needs to be recognised when administrative intervention such as market making is required to force a so called workable competitive market.

QUESTION ONE: APPROACHES

1(a) Has the Authority correctly described the approaches above? If not, please identify any changes to the approach description.

Refer MEUG 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.

In identifying and developing potential approaches the reason market making is required needs to be fully understood. Refer introductory comments above.

1(c) Do you have strong preference or strong aversion to any of the approaches outlined? Please explain your reasoning.

Refer MEUG submission.

QUESTION TWO: KEY TRADE-OFFS

2(a) Has the Authority correctly described the trade-offs above? If not, please identify any changes to the trade-offs.

As per our introductory comments, we contend enforced market making is only required because of the structure of the NZ electricity market ie generation / retail dominated by four large vertically integrated players. The appropriateness or otherwise of this structure is outside the scope of the current consultation. However, rather than other market participants being seen as beneficiaries, integrated generation / retail should be seen as both beneficiaries and exacerbators and as such be required to meet the costs of market making.

Refer also 2(b). Risk impacts willing participation

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.

The paper does not discuss the key issue for those choosing or being required to be market makers ie increasing uncertainty leading to greater unpredictability and therefore risk. 20-25 years ago as the electricity market was established generation was largely hydro backed by base load geothermal, coal, and gas, supported by gas peakers. The pricing risk factor was principally around hydro lake levels and expected inflows. 20 years on the hydro risk remains, however there are also a number of additional factors now in play including: less thermal units (gas and coal), short and medium term gas availability issues, greater reliance non-consistent sources of renewable energy such as wind on any given day. Layered on this is increased economic uncertainty (including two major users considering closure), increased credit risk, and further lock-down scenarios whereby volumes covered by financial instruments exceed physical requirements (the perfect storm).

Avoiding potential catastrophic financial risk would only seem possible if futures offered can be backed by physical means, namely generation or demand reduction. Market participation, other than in the very near term, becomes a speculative activity and we question if this is in the best interests of consumers. Recognising these factors will be key to willing participation by market makers at prices that have relevance for prospective buyers. Points advanced in the November 2019 discussion paper record the place of hedge markets in managing spot price volatility[4]. However, the prices need to be more reflective of a competitive market to be of value to and have the confidence of large consumers and independent retailers

2(c) What trade-offs are most valuable to you, and which are the least valuable to you, and why?

Refer MEUG submission.

QUESTION THREE: KEY TRADE-OFFS

3(a) Has the Authority correctly assessed each approach against the key trade-offs? If not, why not?

The assessments have not taken into account the two key aspects mentioned above:

1. increased risk to participating and the impact this has on efficient pricing
2. the relatively small cost of forced market making is far outweighed by the benefits of being able to operate as a vertically integrated generator / retailer.

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.

Refer comments above.

NZ Steel will be pleased to elaborate on any points made in this submission if required.

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[4] Ibid, para 2.1 and 2.2.