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nova energy

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16 June 2020

Submissions
Electricity Authority
PO Box 10041
Wellington 6143

By email: HME.feedback@ea.govt.nz

Re: Consultation Paper – Hedge Market Enhancements Market Making – Market Arrangements

Nova Energy is the pleased the Authority is scoping out potential enhancements to market making on the ASX electricity futures market.

In addition to the key trade-offs considered in the Consultation paper, Nova proposes that the Authority should consider the expected dynamic efficiency of the alternative approaches. In this respect, Nova suggests that an incentivised voluntary approach should also be considered. This would involve a levy on beneficiaries, but not be as commercially binding on market makers as the Commercial approach. It could be an interim step towards the fully Commercial approach as the level of interest from non-participant market makers becomes more apparent.

Please feel free to contact me if you wish to discuss our views further.

Yours sincerely

Paul Baker

Commercial & Regulatory Manager

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Nova submission

Consultation Paper - Hedge Market Enhancements Market Making – Ensuring market making arrangements are fit-for-purpose over time

Q No.	Question	Response
1.	APPROACHES	
1(a)	Has the Authority correctly described the approaches above? If not, please identify any changes to the approach description.	Nova believes the approaches described capture the key elements that should be considered as part of the Authority's review.
1(b)	Are there any other approaches the Authority should consider? If so, please provide a brief description of the approach and its merits.	The Commercial approach could be supported by a mandatory back-up, e.g. that there shall be at least three of the major gentailers as part of the commercial solution. There is room for considering an incentivised voluntary option. This would have some of the characteristics of the commercial option, but without the limitations of contractual commitments that may be regarded as excessively risky for some parties, at least in the short term. It could be that some non-market participants could be willing to trial market making for NZ electricity futures if there is an incentive to do so but would want to develop a better understanding of the potential risks before signing up for a fixed term contract. It is stated (5.17) that 'A voluntary approach would be unlikely to increase the diversity of market makers…', yet an incentivised voluntary scheme could in fact achieve that.
1(c)	Do you have strong preference or strong aversion to any of the approaches outlined? Please explain your reasoning.	Nova opposes the current voluntary approach with a mandatory backstop. That is simply a mandatory approach in all but name. If it is deemed that the market is not sufficiently liquid under a voluntary approach, then the choice must be between a mandatory or commercial solution; or incentivising the voluntary option as above.

Q No.	Question	Response
2.	KEY TRADE-OFFS	
2(a)	Has the Authority correctly described the trade-offs above? If not, please identify any changes to the trade-offs.	The likely dynamic efficiency of the options should also be factored into the assessment. Market led solutions are more likely to be dynamically efficient than a regulated mandatory solution. The trade-offs described by the Authority tend to blur the costs of the different options because under both the voluntary and mandatory approaches the costs incurred are not apparent to the market. The relative costs of each option are therefore not being compared to the benefits being accrued. The number of market makers is not particularly relevant. It may in fact be a better option to increase the volumes and tighten the conditions on existing market makers than adding another market maker with the additional overheads costs that may create. It is not surprising that many respondents submit that more market makers are a desirable outcome of the review as under the current arrangements: a) the respondents do not incur any of the costs of the additional participant (this is acknowledged in the paper), and b) adding another market maker is a simple parameter to focus on when seeking greater market liquidity.
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 key trade-offs from the different approaches are: a) the benefits accruing to consumers from greater competition and lower prices that should arise from lower capital requirements for retailers, major consumers and generators; and b) the costs of providing the appropriate levels of liquidity and trading margins over a wide range of trading conditions and time periods. There will be a point at which the costs of adding another market maker, or tightening the requirements on market makers, will be greater than the marginal benefit to consumers.

Q No.	Question	Response
		It is important therefore that the best approach is one that helps lead to the appropriate balance between the marginal benefit of increasing market making activity and the marginal cost of that addition. Under the commercial or incentivised voluntary options, the costs are more explicitly identified. This should help ensure the most economically efficient approach is adopted. The dynamic efficiency of the options should also be considered. An incentivised voluntary approach is more likely to lead to an evolution in market making services in response to changing market expectations. A regulated mandatory approach is less likely to achieve this.
2(c)	What trade-offs are most valuable to you, and which are the least valuable to you, and why?	Like any market participant, Nova benefits from having the forward market available to refer to when considering entering wholesale electricity buy or sale contracts, or determining the transfer price between its generation and retail interests. As such, Nova considers it appropriate that the beneficiaries of market making should contribute to supporting a liquid hedge market. Nova is concerned with any suggestion that it should be added to the list of market makers without consideration of the significant additional costs that would oppose on its business.
3.	KEY TRADE-OFFS	
3(a)	Has the Authority correctly assessed each approach against the key trade-offs? If not, why not?	No The 'Voluntary Approach' can only be considered weak to the extent that it fails to deliver an adequately robust forward curve. This could be overcome if it became an 'Incentivised Voluntary Approach', which in effect is a partial Commercial Approach and is very strong. The 'Voluntary approach with a mandatory backstop' has no place in a well governed market. By involving potential market makers in the design process, the appropriate number of market makers can be determined under the 'Commercial approach', and therefore that is a 'Very Strong' attribute, rather than neutral. Under a 'Commercial approach', parties could also choose to transfer their obligations should they choose to do so.

Q No.	Question	Response
		The ‘Mandatory-commercial approach’ presupposes the Authority can strike the right balance in designing the scheme parameters and revenue requirements. That is a brave assumption and could lead to inefficiencies in many forms. ‘Mandatory approach with transferable providers’. The process of seeking replacement providers and negotiation between those parties is likely to be highly inefficient as neither party will be well informed of the likely costs and benefits (unlike the Commercial approach where reasonable terms have been negotiated), and therefore either no transactions will be completed, or there will be a significant transfer of value that may or may not reflect true value. In essence, the theory looks somewhat more promising than the likely end result.
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.	A ‘Mandatory approach’ should be reserved as a back-up to either an ‘Incentivised voluntary approach’ or Commercial approach, i.e. the existing market makers need to understand that in return for receiving compensation for market making activities, they need to be supportive of an electricity futures market that provides a more robust forward curve than it does now. While there is room for incentivising non-market participants to engage in market making, the major gentailers cannot expect to fully devolve all market making to other parties.