

# Hedge Market Enhancements Market Making

NZ Wind Energy Association Submission

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Submissions  
Electricity Authority

By email: [HME.feedback@ea.govt.nz](mailto:HME.feedback@ea.govt.nz)

## Introduction

1. The New Zealand Wind Energy Association (NZWEA) welcomes the opportunity to provide a submission on the Hedge Market Enhancements Market Making consultation paper.
2. The Association also submitted on wholesale market competition in response to the Electricity Price Review (EPR) First Report (October 2018), Options Paper (March 2019) and the Electricity Authority's (EA) November 2019 Hedge Market Enhancements (market making).
3. The Association, in its submissions, focused on two key aspects relating to wind farm development. These were the need to extend the duration of the electricity futures market and the introduction of a capped product to assist management of wind's variability particularly for independent generators without alternate sources of generation or a retail position.
4. While seeking a market duration extension and new product development NZWEA understands the imperative to improve core market making operations and therefore has prepared this submission.

## Executive Summary

5. The Association considers that the most efficient hedge market arrangement is one driven by commercial incentives which would include payment to market makers for services that reflects the cost and benefits of market making.
6. NZWEA therefore prefers the commercial option identified for market making but with a mandatory backstop arrangement also being defined to incentivise the achievement of a commercial arrangement.
7. The consultation paper (para 5.23) summarises the importance of market making and highlights the risk that, without beneficiaries of the service being charged for its cost, it will be challenging to achieve an efficient level of service.
8. The Association therefore considers a key requirement of an effective scheme is to encourage wide participation by having a model which recognises the value of market making and fairly allocates costs to beneficiaries.
9. In the Association's view a commercial model best supports the EA achieving its statutory objective of promoting competition and ensuring efficient operation for the long-term benefit of consumers.

10. The Association recognises the added complexity of a commercial approach including the need to determine incentive payments and cost allocations over a mandatory approach but considers the long-term benefits of ensuring the constructive tension provided by ensuring a beneficiaries pay model is warranted.
11. Doing so is also consistent with the overall commercial operation of the NZ electricity market which operates without subsidies.
12. The Association also notes that, with an increasing level of renewable generation and new market entrants, the importance of an effective hedge market will increase over time. An increasing level of renewables, while the lowest cost source of new generation, may give rise greater price volatility highlighting the importance of continuing to enhance the hedge market by extending the duration and introducing new products such as a cap offering.

## **Response to Specific Questions**

### 13. Question 1: Approaches

The EA has identified the key elements of the different approaches to market making including the hybrid approach of mandatory / commercial.

The Electricity Price Review recommended introducing a mandatory market making approach unless the sector develops an effective incentive based scheme <sup>1</sup>. NZWEA supports the EPR's recommendation and therefore prefers a commercial approach with a suitable payments scheme to incentive market making services. As a backstop, should it not be possible to develop a commercial scheme, the EA should define a mandatory approach which includes appropriate compensation to market makers for services provided. The Association's preference could therefore be defined as a commercial / mandatory approach.

The advantage of a commercial / mandatory backstop approach is that it attempts to create a market making arrangement based on the true usefulness of the scheme by managing costs relative to benefits using a principle of beneficiaries pays. The scheme also potentially encourages wider involvement beyond direct market participants.

A commercial / mandatory backstop approach also avoids the pitfall of a two-tier model which would result if mandatory participants were required to meet their own costs with other participants being offered an incentive payment. Having different cost / incentive arrangements for hedge market participants would not be consistent with the overall commercial basis of operation of the NZ electricity market.

### 14. Question 2: Key Trade-offs.

Para 5.23 of the consultation paper summarises the importance of market making and that all participants who buy and sell electricity benefit from the market. A key factor, which is key to the Association's preference for a commercial model, is the risk noted in the Consultation Paper that if beneficiaries of the service are not charged for its cost it will be challenging to achieve an efficient level of service.

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<sup>1</sup> Electricity Price Review, Final report May 2019 recommendation D2.

The Association therefore considers for the EA to achieve its statutory objective and ensure the efficient operation of the industry the key requirement of an effective scheme is to encourage wide participation by having a model which recognises the value of market making and fairly allocates costs to beneficiaries. Doing so is also consistent with the overall competitive nature of the NZ electricity market which operates without subsidies.

Establishing a commercial model by its nature requires engagement and specification definition and, in the Associations view, enables the key trade-offs identified by the EA to be managed and optimised.

#### 15. Question 3: Key Trade-offs

In reviewing whether the EA has correctly assessed each approach against the key trade-offs the Association has focused on the commercial approach as this is NZWEA's preferred model which is based on a beneficiaries pay principle.

The Association does not agree that commercial approach is neutral in respect of the 'can adjust the number of market makers' trade-off. If an effective scheme is introduced which reflects the value of market making this should encourage participation. By definition if market makers are not attracted the scheme arrangements are not commercial in nature.

Similarly the consequence of non-performance is a function of the commercial arrangement agreed and with a mandatory backstop position there is an incentive, for at least the group of existing market makers, to agree fair and reasonable performance conditions. The Association notes the commercial model scores highly on all other trade-offs.

### **Previously Highlighted Areas for Wholesale Market Development**

16. The Association recognises the need to address market making as a priority but also considers the New Zealand electricity market lags other geographies in the independent development and ownership of generation assets which have been important to the growth in renewables.
17. NZWEA has highlighted in previous hedge market submissions areas for development to better support renewables development including wind energy.
18. The Association focused on two key aspects relating to wind farm development namely extending the duration of the electricity futures market and product innovation to assist management of wind's variability particularly for independent generators.
19. Market Duration

NZWEA considers that an issue with the current market that has not been addressed include the term of the market which should be extended from 3 years to a minimum of 5 years to provide a higher level of contract cover for merchant generators given that new generation assets are a 20+ year investment.

## 20. Product Innovation

The Association also notes that wholesale market product innovation is behind that of other markets. For example, the Australian wholesale market offers a quarterly base load cap on future products. An electricity price cap product was identified as a priority by the EA in December 2015 however for a number of reasons has not been able to be delivered.

While a cap product has a limited direct benefit to a wind farm owner it may enable a retailer to be more prepared to contract with a wind farm owner recognising the variable nature of production and having the ability to manage the absolute level of risk as defined by the cap.

Similarly the ability of independent generators, aggregators of storage and controllable demand to participate in the market needs to be ensured with systems and processes reflective of their scale.

### **About the NZ Wind Energy Association (NZWEA)**

- The NZWEA is an industry association that promotes the development of wind as a reliable, sustainable, clean and commercially viable energy source
- We aim to fairly represent wind energy to the public, Government and energy sector
- Our members are involved in the wind energy sector and include electricity generators, wind farm developers, lines companies, turbine manufacturers, consulting organisations and other providers of services to the wind sector
- By being a member of NZWEA you are assisting the development of wind energy in New Zealand and helping to reduce our greenhouse gas emissions to meet climate change targets.

### **The Association's strategy focuses on three key areas:**

- Leveraging NZ's emission reduction imperative to enable the energy transition to renewables, particularly wind energy.
- Optimising wind energy's position and ensure the regulatory environment supports wind farm development.
- Expanding the opportunity for wind energy development to enable community and industrial projects including wind's integration with other technologies.
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