11 May 2017

Electricity Authority

Financial Transmission Rights Development - Issues and Options Paper

emhTrade is a private investment firm that specialises in trading physical and derivative electricity products in New Zealand. We have been deeply involved in the ftr market as it has evolved to its current form and welcome the opportunity to provide our views on its further development.

We have included detailed answers to the questions posed in the consultation paper and we would be happy to provide further information or to engage in discussion with the Authority about the views expressed in this submission.

Yours Faithfully,

Stuart Innes.

Do you agree that further enhancing the FTR market could support the issues identified by the Authority, and provide benefits to the wider hedge market?

Absolutely. The FTR market is now an inherent feature of the New Zealand Electricity risk management framework and any opportunities for enhancement should be given consideration.

Are there other issues with the current arrangements for FTRs that we have not identified?

Yes. There are a number of issues that we would like to bring to the attention of the Authority:

Market System Improvements.
We have concerns that the 'no fee' structure of the role of the FTR Manager is leading to inefficient outcomes in terms of market development. There are opportunities for market improvements that may be highly valued by some or all participants that are not able to be implemented because they do not pass a CBA in the wider context of the industry. This would not occur in a non-monopoly market for FTR management services. The business case for new features would be based on whether the improvements would generate enough *customer value (participants)* to cover the cost. We think such a structure would result in more rapid and efficient improvement of the market which would, in the long term, assist in the achievement of the Authority's Statutory Objective.
Market Transparency.
In the spot market, bids and offers are published both prior to real-time (aggregated by island, and anonymous), and the day after (by station, and market participant). This transparency gives participants more information with which to asses likely future outcomes. We have trouble reconciling this transparency with the lack of any information about bids in the FTR market. Whilst it may not be possible to publish bids prior to the auction, and it may not be desirable to publish bids after the auction, we think this should be debated. Perhaps a 'market bid curve' may be a suitable middle ground. As stated it is difficult to see how the current approaches in the FTR and Spot markets can both be optimal.

In regards transparency we also note that the positions of participants that trade through OMF are obfuscated from the market. Our view is that to some extent this undermines position transparency as a safeguard in terms of the exploitation of market power. As such we would support any development which involved direct participants having to disclose the parties on whose behalf they may hold any position.

Residual fund allocation.

When the FTR market was implemented, the TPM review was only 1 year from completion and thus the decision on how funds were to be allocated was deferred. Given the TPM review is still at least 1 year from completion we see this as an unresolved issue for the FTR market that is likely to be leading to inefficient outcomes.

Are there any other ways to develop the FTR market that we have not identified? If so, please describe them.

As noted above we think there are numerous ways to improve the market interface, particularly in regards to the publication of data. These improvements could be funded through fees.

What are your views on the relative merits or priority of these twelve potential developments? Could some of them complement or substitute for others?

There is merit in a number of these potential developments, although in our view not in all of them. The priority as we see it, and some commentary is as follows:

1. Increase the number of locations where participants can use FTRs to manage price risks. Improve this process such that voting can not result in some participants 'blocking' additional hubs from reaching the CBA. Whilst we concede a voting process is useful for deciding *which* hubs could be listed, we have concern that votes do not represent economic value, particularly when that value is derived from increased retail competition in certain areas. The inclusion of 'no hub' in a voting process prior to CBA is flawed when voters have incentives that are not aligned with overall economic benefit. We note that recent voting has resulted in only 3 hubs making it to CBA, meaning it is now unlikely that a 4th will be implemented even if that would have a positive net benefit.
2. Auction FTR contracts more regularly. All contracts should be auctioned in all months. This would lower the cost of participation due to the fact that participants could *pick and choose* when to participate, rather than having to be in every auction for fear of missing the opportunity to purchase a product that might not be available for a long time subsequently.

   It would also dramatically improve the ability for participants to make secondary trades, thus encouraging more efficient risk management decisions, and increasing the fungibility between ASX products and FTRs.

   This is also the most effective way to deal with the issue of DSP volatility.

3. Introduce FTRs that allow parties to cover off their risks further in advance.

4. Develop a derivative of a firm option FTR, listed on the ASX. This is the lowest cost and least risk way to achieve all of the following:
   - Allow overseas parties to participate
   - Allow parties to privately fund FTRs
   - Provide a platform that allows participants to trade on the secondary market (although we note that this already exists in the form of a broker)

This would not require a code change and so a *lean or iterative* approach could be taken (eg initially focussing on 1 or 2 paths and iterating from there). It also does not preclude making more costly and permanent changes at a later date if uptake is high.

5. Introduce FTRs that cover only certain times of the day
6. Improve transparency - Including possible publication of market bids and offers.
7. Education
8. Quarterly FTRs - This has been previously discussed at length and we don't see that anything has changed.
9. Firm and non-firm FTRs. This could be better achieved through listing a derivative.

We do not support the opening of the market to Australian participants at this stage due to the fact that a much lower cost, and more easily reversible approach is to list a derivative. We do not support it at all without the ability for parties other than the FTR Manager to originate FTRs.

In regards to the suggestion of a bulletin board for FTR trading, we think this is misguided and will not address the underlying problem that leads to a lack of secondary trading. The reality today is that there is a broker that provides the equivalent service to a bulletin board, and they are not utilised to the the extent that they could be. This service has a cost, but in our view this is not the reason it is not used (see below). We would also not support the cost of this service being passed to consumers through a bulletin board funded by the levy.

In our view the lack of secondary trading is a result of two main factors, neither of which will be addressed through the provision of a bulletin board:

- Poor risk management practice due to vertical integration and the ability for many large participants to rely on 'managing constraints' by increasing generation offer prices during periods of being pivotal upstream of constraints. Now that the Authority has made clear that this behaviour will no longer be tolerated, we expect risk management methods other than exploiting transient market power will become more widespread in the market, thus increasing the propensity for vertically integrated participants to actively manage risk through products such as FTRs.

- High internal transaction costs for many participants. Our view is that although participants may otherwise be willing to trade, their high internal transaction cost means they are better off accepting sub-optimal risk positions. We expect that in time, these internal costs will be reduced through innovation and competition, but this can only occur if the market is structured such that those parties with lower internal transaction costs achieved through innovation are able to transact more frequently. If *lowest common denominator* transaction costs are used when considering improvements to the ability for participants to trade more frequently (such as more frequent auctions, more hubs, longer curve), innovation in risk management will be stifled.

Do you agree the Authority should provide policy direction on the four developments in Group 1, but that service providers can lead further assessment of the developments in Group 2?

We agree that the Authority should provide the policy direction in Group 1 but have concerns about leaving the Group 2 items to service providers when the framework for them making these improvements is flawed.

For example, more frequent trading of FTRs would resolve the issues with DSP price volatility, but under the current framework this issue is the responsibility of the Clearing Manager, whilst the FTR Manager holds the decision that would enable the ideal solution. Similarly the methods by which changes are prioritised may not align with the Authority's Statutory Objective if left purely to the service providers, in that they have incentive to push the decision to participants, which may not be in the long term interest of consumers. We urge the Authority to take a more active role in providing direction and gonvernance to the service providers in regards the items in Group 2.

What are your views on the merits of extending direct participation in the FTR market to parties based in Australia?

As previously noted we do not support extending direct participation to those abroad at this stage, and would not support it at all without the ability for participants to originate or short FTRs. The wider inclusion of participants can only lead to an increase in prices to the detriment of consumers under the current 'long only' market (we recognise the inherent bias in our position and hope that the Authority can disregard this whilst considering our point).

Our research indicates there may be as few as one party that is eager but unable to trade given current arrangements, and to undertake the cost of Code changes and increased monitoring costs for what is far from certain to lead to benefits for consumers seems like an unreasonable risk for the regulator to take. A far more pragmatic and iterative approach would be to support the listing of a 'zero strike inter-hub cap' on the ASX. This would allow participants anywhere in the world to trade an FTR-like product without Code changes or increased monitoring costs.

What are your views on the merits and practicality of allowing parties other than the FTR manager to originate FTRs?

For the reasons already stated, this should be a pre-requisite to allowing foreign participants to trade FTRs. In regards to the practicalities of this, we think the comment in the consultation paper that 'The current auction process also already accepts sales of existing FTRs, so could be modified to accept sales of new FTRs' is likely to be dramatically under-estimating the complexity and cost involved in modifying the proprietary Nexant auction software.

What are your views on the merits and practicality of developing an FTR derivative product?

It is our strong opinion that this is the lowest cost, lowest risk way to address all of the Group 1 issues that the Authority has identified. A good first step might be to just list an option-like product between BEN and OTA so as to have maximum fungibility with the existing products, measure the uptake or otherwise, take feedback, and then move forward from there. There is no need to make decisions at this stage about whether to include all paths or some paths. The only decision is whether to make it firm or non-firm. (eg a derivative of spot or a derivative of the FTRs). No code change is required, and there will almost certainly be people willing to show a price.

What are your views on the merits of developing a bulletin board?

We think there is no merit in this whatsoever. The lack of secondary trading is due to a lack of propensity to trade, which creates a lack of counter-parties. The underlying causes of this need to be addressed and then liquidity will flow through the broker and/or the ASX if products are listed there too.

Now that clarity has been provided in regards to the previously tolerated method of using pivotal pricing to manage location risk, we feel that there is naturally going to be more of a willingness for generators to participate on the secondary markets. However, we are still of the view that there remains a high internal transaction cost for some or all of these parties. In time, this cost will be reduced through innovation and competition (eg through better organisational processes, or through better technology), but only if the market framework is such that those firms that do innovate can be rewarded. More frequent auctions will drive this innovation and address the root cause of a lack of trading far more than the addition of a bulletin board for secondary trading.

Of the two approaches to overcoming the inherent limitations in the supply of FTRs that have been discussed (allowing parties to originate or develop a derivative product), which do you consider preferable and why?

Listing a derivative is clearly the least risky approach to take, although if it could be shown that there would be low cost in adding the functionality to originate to the auction, clearing and settlement processes, then we would support this. We don't see that as likely though.

Are there other approaches to overcoming the inherent limitations in the supply of FTRs that the Authority has not identified?

The FTR Manager should be held more firmly accountable to its target of revenue inadequacy once in every twelve months. This should be measured using a statistical approach, by an independent third party, on a far more frequent basis than is currently being done.

What are your views on how these developments would complement each other? To what extent might they be dependent on each other?

Listing a derivative is by far the most compelling development, it is likely the lowest cost and resolves all of the identified issues. As previously stated we do not support extending direct participation to overseas parties currently, and in any case not without the ability to originate FTRs. This is consistent with other jurisdictions such as Australia that do not allow participation in physical or rental markets to overseas parties.