Contact

9 May 2017

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

By email: submissions@ea.govt.nz

Dear Authority

Financial Transmission Rights development: Issues and options paper

Thank you for the opportunity to provide feedback on the Electricity Authority's (Authority) Financial Transmission Rights (FTR) development: Issues and options consultation paper.

Contact is of the view that the current FTR market is functioning satisfactorily and does not believe the additional costs of the proposed changes will be outweighed by the benefits.

Our position can be summarised as follows:

- If the Authority does wish to proceed with any of the proposed changes in this consultation it is important that the issue of liquidity and the potential to self-fund ('originate') FTRs is considered and appropriately analysed first;
- Whilst Contact is broadly supportive of providing the ability to participants to originate FTRs, there is work to be done to ensure all the risks and operational implications are appropriately addressed. This information needs to be provided to the market before a reasoned response can realistically be made;
- Contact does not believe that there is enough evidence in the consultation paper to suggest that extending participation to Australian entities will have a positive benefit on the New Zealand electricity market; and
- Should the Authority decide that participation is to be extended, this should only be considered once the ability to originate FTRs has been appropriately analysed and introduced.

A detailed response to the Authority's questions is provided in the Appendix below. Should you wish to discuss any of the matters raised in this submission please don't hesitate to contact me on 04 462 1028.

Yours sincerely,

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Manager, Forward Markets

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Appendix

Contact Energy's Response

Question	Contact Energy Comment
Q1. 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?	Contact believes that the current Financial Transmission Right (FTR) market is functioning satisfactorily and does not believe the additional costs of the proposed changes will be outweighed by the benefits. Instead of increasing competition, reliability and efficiency, Contact is of the view that some of these proposed changes could make participation and compliance in the New Zealand FTR market increasingly complex and costly.
Q2. Are there other issues with the current arrangements for FTRs that we have not identified?	No.
Q3. Are there any other ways to develop the FTR market that we have not identified? If so, please describe them.	No.
Q4. What are your views on the relative merits or priority of these twelve potential developments? Could some of them complement or substitute for others?	Contact does not believe that all of the proposed developments are necessary. However, in terms of priority, Contact is of that view that undue weight has been assigned to allowing overseas participants to trade FTRs directly. It is our view that priority should instead be focused on allowing FTR participants to self-fund FTRs ("origination") before considering expanding the participation to non-New Zealand based entities. The relative merits of origination and overseas participants are discussed in more detail in questions 6 -9. Merits of other options are discussed below: 1. **Adding FTR hubs under the allocation plan process** Contact believes that the introduction of additional FTR hubs needs to be considered carefully. As discussed in previous consultations, each additional hub increases costs on participants exponentially. When adding hubs, a real benefit to the market needs to be demonstrated without degrading the usefulness of the existing products.

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	2. **Support FTR education** Contact is broadly supportive of any additional education around FTRs, provided any educational options provide good value for money. 3. **Auction all FTR contracts each month** Contact does not believe auctioning all contracts each month is either desirable or realistic. Analysing and constructing bids for this many products would be extraordinarily time consuming and would likely require further head count to manage the workload. The volume of auctions would make it more difficult to assess interaction of each product and provide transmission analysis when pricing and assessing risks. The increased auction frequency would also increase the risk of over allocation. 4. **Introduce a "peak" or "Super Peak" FTR product** Given the relative lack of uptake of these type of products in other markets (notably the ASX), it is hard to see how the introduction of this product would provide any additional utility to the FTR market. FTRs are already relatively complex, and increasing complexity by introducing more products does not seem like a logical way to increase participation. 5. **Introduce a quarterly FTR product or strip product** Contact has been supportive of quarterly products in the past, however, our continued support would depend on how the proposed products are structured and the costs of development. 6. **Extend FTR price horizon** Contact does not see any significant benefit in increasing the time horizon on FTRs from 24 to 36 months. With a 36 month time horizon, risk of over allocation increases, as credible transmission outage information is usually only available 1 year out. This means two thirds of the auction periods will be completed without reliable transmission outage data. It is also unclear how the additional months will be auctioned. Contact assumes that the number of auction months released at each auction would need to increase to accommodate the additional

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	months. This would again increase workload on participants and result in bidding in more auction periods where there is increased uncertainty around supply, demand and transmission outages. 7. **Introduce FTRs with preferential pay-outs** Given that there have been no instances of scaling to date, the introduction of different types of FTRs with preferential pay-outs would seem to add unnecessary complexity to the market. It is unclear how scaling would be applied across the two products and how the preferential bidding process would work in practice. We assume that scaling risk cannot be completely eliminated from the preferential product unless the FTR manager is seeking to procure outside financial backing to guarantee pay out. Contact is also concerned that the development of two pools could create a "prisoner's dilemma" where participants only bid for preferential FTRs because the risk of being the only one in the non-preferential pool means all scaling may be applied to your portion of FTRs potentially leaving you with no cover at all. 8. **Improve transparency around FTR market** *Require disclosure of FTRs through intermediaries* Contact does believe that the use of intermediaries to build anonymous positions in the FTR market, whilst others are required to disclose their positions, is creating asymmetry of information and may create unfair advantage to some parties. However, at this stage Contact does not think the number of parties utilising intermediaries warrants a rule change. Contact's main concern is generators using intermediaries to build up "pivotal positions". This is something that would need to be investigated further and Contact would support the development of safeguards around this behaviour. *Publish auction bids* It is unclear from the consultation if this would be the disclosure of auction bids in an anonymous nature or with the parties name against them. Contact considers auction bids to be commercially

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	sensitive and believes the requirement to publish bids would more likely discourage new participants especially speculators from participating in the market.
Q5. 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?	Contact agrees that any aspects that require code changes should be monitored by the Authority, however, Contact believes that the FTR manager is still better placed to monitor and assess the market and operational impacts.
Q6. What are your views on the merits of extending direct participation in the FTR market to parties based in Australia?	Much of the discussion in the consultation around extending trading to Australian based parties is based on theoretical benefits and lacks any evidence that extending participation to Australian parties will deliver on the Authority's objectives. Contact does not believe that there is enough evidence in the consultation paper to suggest that extending participation to Australian entities will have a positive benefit on the New Zealand electricity market. The Authority notes that significant legal issues need to be worked through to allow Australian or other non-New Zealand based entities to participate in this market. What is unclear is if these investigations would result in changes needing to be made to the New Zealand FTR market to accommodate non-New Zealand participants. Contact believes the market should be provided detailed information around this legal advice and potential operational impacts before a final decision is made. The Authority notes in the consultation paper that overseas participants are already able to access the FTR market through third parties. This would appear to us to be the lowest cost solution and avoids any legal and implementation costs. Contact disagrees with the Authority's comment that FTRs trading below the final settlement price shows that bidding is opportunistic. We consider this to be a mistaken view of the market, especially a market that faces volatile climatic events and significant transmission risks. To have final settlement prices close to auction clearing prices would require perfect foresight which is unrealistic. Clearing of products at low prices may reflect the actual value of the product and is not necessarily due to a lack of participation or opportunistic bidding.

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	The Authority has stated it has no concern around wealth transfer unless it has broader economic efficiency impacts. The Authority also notes that those parties seeking to hedge risk for their portfolio will "value FTRs more highly"[1] and therefore "more likely to acquire" the volume. By introducing more participants, those parties seeking to manage locational risk with FTRs may have to pay a higher price to secure volume. Paying higher prices to cover risks or a retailer missing out on FTR volume because of high demand, creates inefficiencies through retailers not being able to offer the consumer competitively priced products in areas where they cannot secure competitive hedging. However, should the Authority decide that participation is to be extended, the perceived benefits of competition will require an increase in liquidity to be realised, and this can only occur if parties are able to originate FTRs. We believe there are many aspects of origination that still need further analysis. Contact would like to understand how the origination of FTRs in the market would impact on scaling. Under a scenario where all FTRs (FTR manager & privately funded) are scaled equally, it would seem to us that there is potential for increased scaling due to the increased volume of FTRs sold. Contact is not convinced that the introduction of additional FTR participants will lead to increased availability of hedging through the ASX futures market. The ability to use FTR's to increase a participant's appetite to take on outright ASX positions (those that exclude basis swaps) appear limited.
Q7. What are your views on the merits and practicality of allowing parties other than the FTR manager to originate FTRs?	Contact is broadly supportive of providing the ability to participants to originate FTRs. However, there is work to be done to ensure all the risks and operational implications are appropriately addressed. The calculation of prudential and management of credit risk is a substantial undertaking and important to ensuring confidence in the FTR market. Whilst Contact does acknowledge that the ability to buy FTR obligations does provide similar credit risk, FTR option sales only have one sided payback so the downside risk is unbounded with

[1] Financial Transmission Rights Development: Issues and Options Paper, section 6.22.

	limited upside. The importance of daily settlement prices (DSPs) accurately reflecting true FTR value is important to avoid any instance of default. Contact queries whether the risk premium required by originators may be higher than what the market is willing to pay the pool. The pool itself has no underfunding risk due to scaling. Contact is of the view that scaling risk will actually work as an advantage when encouraging sellers to provide liquidity to the market, as it reduces their exposure during periods where scaling may occur. Further analysis will also need to be provided around other potential implications of participant origination such as the effect of parties offering volume on a node that had previously been oversold, and could heavy selling at various nodes lead to obscure market outcomes. In general, Contact would like to see more analysis around the impact of origination on the FTR market before a final decision is made.
Q8. What are your views on the merits and practicality of developing an FTR derivative product?	Contact is not convinced that a derivative product for FTRs will gain much traction, especially if it is run through the ASX. By listing the derivative on ASX, parties could be managing prudential on FTRs through two different exchanges (NZX and ASX). Whilst the derivative on the ASX matches better with those trading NZ electricity futures, these are limited to BEN_OTA FTR products, therefore the bulk of FTRs may still be trading through the FTR platform. Also, trading on the ASX may increase costs for participants, which could lead to reduced access to FTRs that have been bought in the FTR market and sold through the ASX platform as a derivative. This would essentially disadvantage any entities who may have been interested in trading a FTR derivative if they were able to use it to manage their spot market prudential with NZX.
Q9. What are your views on the merits of developing a bulletin board?	Contact believes the costs of setting up and monitoring a bulletin board would ultimately outweigh the benefits.
Q10. 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),	If it is to occur, Contact believes that origination should occur within the FTR market, rather than via another platform (i.e. derivative on the ASX). Contact considers a broader range of sellers are likely to participate if selling is managed through the platform where the bulk of the FTR volume is traded and that allows prudential to be

which do you consider preferable and why?	managed through NZX. However, we feel that we need to see more information around origination and its impacts on the FTR market before making any final decisions.
Q11. Are there other approaches to overcoming the inherent limitations in the supply of FTRs that the Authority has not identified?	No, the proposed methods seem the most logical avenues of supply.
Q12. What are your views on how these developments would complement each other? To what extent might they be dependent on each other?	As discussed previously, development of origination of FTRs needs to be considered and developed before expansion of the scheme to include Australian or other overseas participants.

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