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9 May 2017

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TRUSTPOWER SUBMISSION: FTR DEVELOPMENT ISSUES AND OPTIONS PAPER

1 Introduction and overview

1.1.1 Trustpower Limited (**Trustpower**) welcomes the opportunity to provide a submission to the Electricity Authority (**the Authority**) on its *FTR Development Issues and Options Paper* (the **Options Paper**[1]).

1.1.2 We understand that the Authority is considering opportunities to further develop the market for Financial Transmission Rights (**FTR**).

1.1.3 The Authority has identified twelve options for further developing the FTR market, and how it integrates with other markets for managing wholesale electricity price risk. These options can be classified as improvements that either:

a) require policy direction, in which case the Authority considers it is best placed to further consider these options (**Group 1**); or

b) could be progressed directly by the FTR Manager and Clearing Manager (**Group 2**).

1.1.4 The four options classified as Group 1 are:

a) Allowing for direct overseas participation in FTR trading;

b) Allowing parties other than the FTR manager to originate FTRs;

c) Developing a FTR-like derivative product; and/or

d) Supporting secondary trading with a bulletin board.

1.1.5 The eight options that are classified as Group 2 are as follows:

a) Adding additional FTR hubs under the allocation plan process;

b) Supporting FTR education;

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[1] http://www.ea.govt.nz/development/work-programme/risk-management/hedge-market-development/consultations/#c16389

c) Auctioning all FTR contracts each month;

d) Introducing a "peak" or "super peak" FTR product;

e) Introducing a quarterly FTR product or strip product;

f) Extending the FTR price horizon;

g) Introducing FTRs with preferential pay-out priorities; and/or

h) Improving transparency around FTRs.

1.1.6 The Options Paper seeks the views of interested parties on the merits and priority of each of the identified options.

2 Trustpower's views

2.1.1 We continue to consider that the current FTR arrangements:

a) are not the most efficient (i.e. cost-effective) solution to the underlying issue of managing locational price risk; and

b) have introduced unnecessary complexity into the market design.

2.1.2 Our preferred simpler option for managing locational risk would have been for all LCE to be refunded to retailers, who in aggregate have overpaid at the load nodes as a result of locational marginal pricing being adopted[2]. The LCE would be paid to retailers in proportion to their spot market purchases, and in a competitive market would be expected to be passed through to consumers, thereby achieving the statutory objective without needing any form of complex trading arrangements.

2.1.3 We acknowledge, however, that the investment has already been made by the market to implement the current FTR arrangements. We consider that on this basis the unmodified status quo should be maintained.

2.1.4 A number of the options outlined in the Options Paper would move the current arrangements even further away from providing a simple, cost-effective solution to managing locational price risk, through creating a further layer of complexity.

2.1.5 We consider that introducing further complexity into the FTR arrangements is unlikely to be justified at this time, as there does not appear to be a market need for any improvements (refer to our section 3 below).

2.1.6 There may be some merit in improving education and transparency around FTRs.

2.1.7 Further details of Trustpower's views on each of the options that have been identified by the Authority are outlined in Appendix 1. Our responses to the Authority's specific questions are provided in Appendix 2.

3 Unclear there is currently a market need for the identified potential improvements

3.1.1 A number of the options being considered in the Options Paper were previously discussed by the Locational Price Risk Technical Group (**Technical Group**).

3.1.2 At its September 2013 meeting[3], it was agreed by the Technical Group that:

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[2] We note that constraints impacting on generation could also be separately refunded to impacted generators as well through this simpler arrangement.

[3] http://www.ea.govt.nz/development/advisory-technical-groups/disestablished-groups/lprtg/meeting-papers/2013/25sep13/

a) the increased complexity associated with expanding the FTR market to a number of additional nodes would reduce the identified benefits of the overall reform; and

b) a roadmap be established for considering whether residual locational price risk was still a commercial concern. Note that the Technical Group acknowledged that periodic review of locational price risk would have to be considered against other priorities in the Authority's work programme.

3.1.3 Similarly, matters such as the specification of the availability horizon for FTRs and enabling overseas participants to trade FTRs were also discussed by the Technical Group, and decisions were made to not progress those changes at that time.

3.1.4 The FTR market has however continued to evolve since its initial commencement in 2013 which the Authority considers has been very positive. In fact that Authority considers the market has generally been functioning well[4]; we are therefore surprised that the Authority had prioritised investigating potential opportunities to further improve the FTR arrangements.

3.1.5 The Authority outlines in the Options Paper, five issues with the current FTR arrangements:

a) Barriers to participation in the FTR market;

b) Limited ability to purchase or resell FTRs as and when desired;

c) The assessment of an FTR's daily settlement price can be volatile;

d) Inability to cover all locational price risk with FTRs; and

e) Inability to perfectly mesh FTRs with other commonly-used hedge products.

3.1.6 We have not experienced any of these issues and therefore do not agree that they are impacting the efficiency and effectiveness of the current FTR arrangements.

3.1.7 We are concerned that there is not currently a real market need for the new, more complex arrangements (i.e. there is no current regulatory failure to address). Subsequently we consider that progressing the majority of the identified options to further improve the FTR arrangements is not justified at this time.

3.1.8 While the enhancements may move the arrangements further towards a theoretically perfect outcome, unless there is a real market need the new more complex arrangements will result in greater costs, more diluted liquidity and a barrier to entry for potential new retailers.

3.1.9 We appreciate the Authority has had some discussions with stakeholders around these matters but caution that parties indicating an interest in further FTR market development and parties actually participating in the new arrangements can be quite different.

3.1.10 For example, the market for options and peaks on the ASX is not currently liquid. This market, along with baseload quarterly and monthly futures, would enable relevant parties to manage a very high proportion of locational price risk and yet it is not being actively traded. This raises the important question of "why?" and could be illustrative of the fact that participants do not have a compelling need for additional products to manage their risk.

3.1.11 It is also important that the Authority considers whether anyone will actually supply additional FTRs or derivative type products.

3.1.12 Prior to making any decisions around further enhancements to the FTR arrangements, we support the Authority in:

a) Investigating why there is only very limited trading on the ASX of option and peak products; and

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[4] Refer to paragraph 3.25 of the Options Paper.

b) Considering who will likely supply additional FTRs or derivative type products and what the long-term net benefits are that this will create for NZ.

For any questions relating to the material in this submission, please contact me on 07 572 9888.

Regards,

C. Schubauer

CRAIG SCHUBAUER
WHOLESALE MARKETS MANAGER

Appendix 1: Trustpower's view on each of the identified options

Option	Group	Trustpower's views
Allow for direct overseas participation in FTR trading	Group 1	• It is unclear whether there is a real market need for enabling overseas participation at this time. • There is a risk that additional complexity will be introduced unnecessarily unless there are a number of overseas parties ready and willing to participate.
Allow parties other than the FTR manager to originate FTRs	Group 1	• The Authority should investigate whether any parties will actually create FTRs. This is expanded on further in section 3 of our submission. • If other parties are able to originate FTRs, it will be important that appropriate prudential arrangements are provided to support the sale of any FTRs. We note that the risk of default of an option seller is far greater than an option buyer. • We are concerned that the options (particularly those in Group 1) would result in a move away from having a physical link to generation and consumption which currently underpins the FTR arrangements. • If this option is progressed it will be important that the FTRs created by the FTR manager and those created by other parties are interchangeable / fungible. It is not clear how this will be achieved, given that the FTRs created by the FTR manager will always be non-firm. Will the FTRs originated by other parties have the same degree of firmness?
Develop a FTR-like derivative product	Group 1	• The Authority should investigate whether any parties will want to trade an FTR-like derivative product. This is expanded on further in section 3 of our submission.
Support secondary trading with a bulletin board	Group 1	• Brokerage arrangements already exist which enable secondary trading to occur. Through brokers, and the current suite of products which include FTRs, futures and contracts for difference, parties currently have a large range of options available to manage their specific market risks.

Option	Group	Trustpower's views
		• If there were a market need, this would be actively pursued already through the existing arrangements. This suggests that there is no current market need for a bulletin board.
Add FTR hubs under allocation plan process	Group 2	• We disagree with the increase in the number for FTR hubs to nine currently proposed. For further details of our views please refer to our recent submission to the FTR manager: http://www.ea.govt.nz/development/work-programme/operational-efficiencies/changes-to-the-ftr-allocation-plan/consultation/#c16152
Support FTR education	Group 2	• We support greater education on how the FTR market works being made available for all interested parties, including the interaction between residual LCE and FTR payments.
Auction all FTR contracts each month	Group 2	• It is unnecessary to increase the frequency of FTR auctions. For further details of our views please refer to our recent submission to the FTR manager: http://www.ea.govt.nz/development/work-programme/operational-efficiencies/changes-to-the-ftr-allocation-plan/consultation/#c16152
Introduce a "peak" or "Super Peak" FTR product	Group 2	• There are currently ASX products which enable parties to manage peak risks. • Once liquidity in the ASX peak products increases it may provide an indication of a demand for FTR peak product. Until that time we do not consider it is necessary to introduce a peak or super peak FTR product.
Introduce a quarterly FTR product or strip product	Group 2	• There may be value in the FTR manager considering replacing longer products with a strip product, however there may be better options directly available through the ASX which would mean costs to industry could be minimised.
Extend FTR price horizon	Group 2	• Currently the outage plans published by Transpower only cover a 12 month period. As result there is no transparency around the need for FTRs in managing outage risk more than 12 months ahead. • The current arrangements essentially mean that purchasers of FTRs are "in the dark" around the need for FTRs when purchasing between 12 and 24

Option	Group	Trustpower's views
		months in advance. Further increasing the time horizon would simply further exacerbate this issue of outage uncertainty, and therefore the risk of revenue inadequacy occurring. We note that as uncertainty increase, willingness to buy FTRs will decrease (and conversely willingness to sell will increase).
Introduce FTRs with preferential pay-out priorities	Group 2	• This possibility was debated at length by the Technical Group. Introducing FTRs with preferential pay-out priorities would create unnecessary additional complexity. • Our understanding was that the Technical Group concluded that the number of "firm" FTRs that could be sold was approximately zero. We do not consider that any significant change has occurred in the market since this issue was originally considered by the Technical Group that would now warrant consideration of creating two tranches. • As above, it is unclear under the proposed new arrangements whether if a participant (other than the FTR manager) creates a FTR, they will be called for full pay out even if the equivalent grid-based FTRs are revenue inadequate.
Improve transparency around FTRs	Group 2	• In principle we support greater transparency around FTRs. It is however important to ensure that transparency occurs on both the buy and supply side.

Appendix 2: Responses to the Authority's questions

Question	Response
1. 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.	1.1 We generally do not agree that these potential issues are currently impacting on the efficiency and effectiveness of the current FTR arrangements. 1.2 Further details of our concerns that there may not be an actual market need at this time for the identified potential improvements are outlined in section 3 of the cover letter of this submission.
2. Are there other issues with the current arrangements for FTRs that we have not identified?	2.1 We consider that the current arrangements operate as originally intended and that no material issues warranting further development of the arrangements have arisen to date. 2.2 Details of our preferred simpler option for managing locational risk are outlined in section 2 of the cover letter of this submission.
3. Are there any other ways to develop the FTR market that we have not identified? If so, please describe them.	3.1 Refer to our response to question 2.
4. What are you views on the relative merits or priority of these twelve potential developments? Could some of them complement or substitute for others?>	4.1 Our specific views on each of the identified options are outlined in Appendix 1 of this submission.
5. 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?	5.1 We do not consider it is necessary to take the majority of the options further forward at this time. The exceptions to this are that we believe the FTR manager should consider improving transparency around FTR s and supporting FTR education. 5.2 To the extent that they may become relevant in the future then we agree that those options outlined in Group 1 would require policy direction.

6. What are you views on the merits of extending direct participation in the FTR market to parties based in Australia	6.1 We consider it is unclear whether there is a real market need for enabling overseas participation at this time. 6.2 Further details of our views around this option are outlined in Appendix 1.
7. What are your views on the merits and practicality of allowing parties other than the FTR manager to originate FTRs?	7.1 We are not certain whether any parties will actually create FTRs. We recommend the Authority considers this further before making any decisions to progress this initiative. This point is expanded on further in section 3 of the cover letter of this submission. 7.2 If the Authority does progress this option further then we consider it will be important that: a) appropriate prudential arrangements are put in place to ensure the market is appropriately protected when FTRs are created by parties other than the FTR manager; and b) FTRs created by the FTR manager, and those created by other participants, are fungible. This means that they will have to have the same characteristics of revenue (in)adequacy. 7.3 Further details of our views around this option are outlined in Appendix 1.
8. What are your views on the merits and practicality of developing an FTR derivative product?	8.1 We consider that the Authority needs to investigate whether any parties will want to trade an FTR-like derivative product. 8.2 Further details of our views around this option are outlined in section 3 of the cover letter of our submission, and Appendix 1.
9. What are your views on the merits of developing a bulletin board?	9.1 We do not consider there is currently a market need for a bulletin board and note that this is demonstrated by the fact that these type of arrangements have not currently been actively pursued. There is no current impediment to a bulletin board being created. 9.2 Further details of our views around this option are outlined in Appendix 1.
10. Of the two approaches to overcoming the inherent limitations in the supply of FTRs that have been discussed (allowing	10.1 We consider neither approach is required at this time.

parties to originate or develop a derivative product), which do you consider preferable and why?	
11. Are there other approaches to overcoming the inherent limitations in the supply of FTRs that the Authority has not identified?	11.1 We have not identified any other options.
12. What are your views on how these developments would complement each other? To what extent might they be dependent on each other?	12.1 As outlined above, we do not consider that any further enhancements to the current FTR arrangements are required at this time.