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9 May 2017

Submissions  
Electricity Authority  
PO Box 10041  
Wellington 6143

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

Dear John

## Financial Transmission Rights market development

We welcome the opportunity to submit to the Authority's consultation *Financial Transmission Rights (FTR) development* published 28 March 2017. Transpower, through its commercial arm Energy Market Services (EMS), has been the FTR manager since the market's inception in 2013.

As FTR manager we have been working with the Authority, the clearing manager and the FTR user group to advance positive and practical changes to the FTR market. We are pleased that the Authority acknowledges the FTR market is generally functioning well and that progress to date has been positive.<sup>1</sup>

Appendix A provides feedback from the FTR manager to the questions asked.

### We support development of the FTR market

We agree with the Authority that there are barriers to participation in the FTR market, including complexity. We strongly support investment in FTR market education as a low risk means to incentivising broader participation.

We also support the Authority's consideration of the merits of expanding FTR market participation to Australia. We have obtained legal advice on the compliance requirements for the FTR manager offering FTRs and related markets in Australia.<sup>2</sup> We consider the compliance requirements should not be an impediment to expanding into Australia but the costs of the attendant legal processes would need to be recognised in an increased scope for the FTR market administration.

We consider that the Authority is best placed to assess the costs and benefits of market expansion for the long-term benefits to New Zealand consumers, not just to the FTR market and its participants.

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<sup>1</sup> Section 3.25

<sup>2</sup> Provided to the Electricity Authority on 14 April 2016 under common interest legal privilege

## Alternative market development proposal: Joint Energy and Transmission Rights Auction (JETRA)

We consider a significant practical issue from the proposals for external derivatives, externally originated FTR's and energy hedges is that they would not meet the *simultaneous feasibility* test (SFT). The SFT is a consistent measure understood by participants as proof of an optimised auction solution, and provides high confidence that revenue adequacy will be achieved.

We propose an alternative development proposal, a joint energy and transmission rights auction (JETRA). We consider JETRA has huge potential to:

- increase the funds for additional FTR capacity
- provide additional energy hedging, and
- develop more products e.g. *point-to-point options* (expressed as a key challenge for market development).

Adoption of JETRA could in principle be made with relatively simple modifications to existing software and processes (although we would need to explore this further with the system vendor).

Further advantages are that the JETRA approach would improve the ability to purchase or resell FTRs as and when desired and provide a broader mechanism for communicating pricing signals. We consider it goes some way to address the risk of scarcity pricing for limited FTR supply caused (in part) by extending participation. The approach allows seamless integration with the FTR market, and for simultaneous feasibility to be maintained as capacity and participation are increased.

We would be keen to work further with the Authority and the market to discuss and evaluate the benefits and possibilities under a JETRA framework.

Please contact Richard Rowell, Manger EMS Operations<sup>3</sup> in the first instance if you have any questions about this submission.

Yours sincerely



Micky Cave

**Senior Regulatory Analyst**

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## Appendix A FTR manager response to questions

|    | Question   | Comment  |
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| 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? | <p>Yes.</p> <p>The FTR manager is keen to continue to work with stakeholders on advancing the changes already identified as desirable by the user group.</p> <p>For FTR market participation, we agree that the Authority should be responsible as the agency with the statutory objective for the long-term benefit of NZ consumers.</p> <p>We describe an alternative development that we consider could provide benefits from a more liquid market (price efficiency and reduced volatility) with reduced costs and risk. Refer to our response to question 3</p>   |
| 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  | <p>Yes.</p> <p>We consider a significant practical issue from the proposals for external derivatives, externally originated FTR's and energy hedges is that they would not meet the <i>simultaneous feasibility</i> test (SFT). The SFT is a consistent measure understood by participants as proof of an optimised auction solution, and provides confidence that revenue adequacy is achieved.</p> <p>We propose an alternative development proposal, a joint energy and transmission rights auction (JETRA). We consider JETRA has huge potential for increasing the funds for additional FTR capacity, in providing additional energy hedging, and in developing more products (for example <i>point-to-point options</i> (expressed as a key challenge for market development). Adoption of JETRA could in principle be made with modifications to existing software and processes (although we would need to explore this further with the system vendor).</p> <p>Further advantages are that the JETRA approach would improve the ability to purchase or resell FTRs as and when desired, gives a broader mechanism for communicating pricing signals, and goes some way to address the risk of scarcity pricing for limited FTR supply caused (in part) by extending participation. The approach allows seamless integration with the FTR market, and for simultaneous feasibility to be maintained as capacity and participation increased.</p> <p>We would be keen to work further with the Authority and the market to discuss and evaluate the benefits and possibilities under a JETRA framework.</p> |

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| Q4 | <p>What are your views on the relative merits or priority of these twelve potential developments? Could some of them complement or substitute for others?</p> | <p>We think that the following have merit for the EA or service providers to <b>pursue</b>:</p> <ul style="list-style-type: none"> <li>a) Allow for direct overseas participation in FTR trading</li> <li>e) Add FTR hubs under allocation plan process</li> <li>f) Support FTR education</li> <li>l) Improve transparency around FTRs</li> </ul> <p>We think that any policy need to increase supply of FTRs would be best met by a JETRA approach than by allowing parties other than the FTR manager to originate FTRs or by developing an FTR-like derivative product.</p> <p>We therefore think that the following are <b>not worth pursuing</b> before JETRA:</p> <ul style="list-style-type: none"> <li>b) Allow parties other than the FTR manager to originate FTRs</li> <li>c) Develop an FTR-like derivative product</li> </ul> <p>The following options are on our standard long list for FTR Allocation Plan consultation. We believe that they <b>should remain on the long list</b>, but to date there has been little FTR user group support for them. The FTR Manager could implement them if FTR users and the EA agree.</p> <ul style="list-style-type: none"> <li>d) Support secondary trading with bulletin board: the bulletin board (a software change) has been consulted on as part of each Allocation plan. Each time the FTR user group deferred the change as not currently required. <ul style="list-style-type: none"> <li>• A Bulletin Board would create inefficient double handling, as all trades agreed via the Board must be subsequently captured by the Assignment Editor</li> <li>• We consider other activities could be undertaken to support growth in the secondary market and reduce the need for a bulletin board. For example, the <i>Assignment Editor</i> in our Nexant iHedge system has some level of functionality that enables FTRs to be requested or offered. These features could be developed, and supported with participants through education.</li> <li>• Reconfiguration auctions (all Variation and two-thirds of all Primary auctions) allow for participants to sell FTR MW into the auction pool. While they are limited to FTRs for the periods offered by the auctions, it is proving an increasingly viable tool for market liquidity. For example, in the April 2017 auctions 268MW was awarded (cleared) from sell offers alone. This is perhaps a further reason limiting the impact and benefit of the proposed bulletin board.</li> </ul> </li> <li>g) Auction all FTR contracts each month: a special case of a review of the FTR Calendar</li> <li>h) Introduce a “peak” or “Super Peak” FTR product</li> <li>i) Introduce a quarterly FTR product or strip product: might require difficult and costly modifications to the Nexant iHedge system</li> <li>j) Extend FTR price horizon</li> <li>k) Introduce FTRs with preferential pay-out priorities</li> </ul> |
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| 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?                                 | <p>We agree group 1 developments (a) (b) and (c) should, if developed, be developed by the Authority as the agency with the statutory objective for the long-term benefit of NZ consumers. The JETRA option should be added to this list as a priority over (b) and (c).</p> <p>We consider (d) secondary trading would be more appropriate in the second group for service providers to pursue.</p>  |
| Q6  | What are your views on the merits of extending direct participation in the FTR market to parties based in Australia?   | <p>We support expanding participation in the FTR market, both in New Zealand and Australia. There would be additional compliance requirements for expansion into Australia and additional costs for the attendant legal processes.</p>  |
| Q7  | What are your views on the merits and practicality of allowing parties other than the FTR manager to originate FTRs?   | <p>We consider there would be significant practical and revenue adequacy issues to address if externally originated FTR's were to be sold through the same auctions, resulting from the simultaneous feasibility issues discussed above.</p> <p>If the Authority does decide to continue with these options, we believe that the FTR Manager could assist with research and development on the complex and potentially insoluble issues of integration.</p> <p>Our preference is to adopt an alternative approach via JETRA. The FTR Manager would assist with research and development for this alternative market development</p> |
| Q8  | What are your views on the merits and practicality of developing an FTR derivative product?  | <p>We consider there are significant technical / practical issues to address in developing an FTR derivative product, specifically, how to maintain simultaneous feasibility with the "external generation"?</p> <p>Our preference is to adopt an alternative approach via JETRA. The FTR Manager would assist with research and development for this alternative market development.</p>   |
| Q9  | What are your views on the merits of developing a bulletin board?  | <p>Please refer to question 4, and we'd be happy to re-validate participant demand for this change.</p>   |
| 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), which do you consider preferable and why? | <p>We consider neither would not meet the <i>simultaneous feasibility</i> test (SFT).</p> <p>Our preference is for additional consideration of an alternative approach via JETRA.</p>   |
| Q11 | Are there other approaches to overcoming the inherent limitations in the supply of FTRs that the Authority has not identified?   | <p>The supply of FTRs has increased as new hubs are added and through the FTR Manager's market reviews recommending (to date) capacity increases. Of course, both have a finite limit.</p>  |

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|     |  | The only other approach of which we are aware that maintains the critical simultaneous feasibility relationship is the Joint Energy and Transmission Rights Auction. |
| Q12 | What are your views on how these developments would complement each other? To what extent might they be dependent on each other? | <p>Development <b>a</b> complements developments <b>b</b> and <b>d</b>.</p> <p>Development <b>c</b> complements <b>a, d, g, h, i, j, and k</b>.</p>                  |