



04 July 2022

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

To whom it may concern,

Re: Financial Transmission Rights market review

Thank you for the opportunity to submit on the Electricity Authority's ('Authority') observations and concerns around the performance of the Financial Transmission Rights (FTR) market.

Contact has been a participant in the FTR market since its inception and has found them to be a useful product for managing locational price risk.

Future locational price risk will vary based on changes in regional demand, the location and extent of new generation and upgrades to transmission capacity. We believe FTRs offer the required flexibility to adapt to these changes and assist with management of short-term locational price risks.

There are currently few options available to manage locational price risk, and in our experience, over-the-counter (OTC) transactions provide a very limited ability to hedge locational price risks.

FTRs provide the most liquid form of location price risk hedging available in the market and we are supportive of the continued development of the FTR market. In our response, we outline some of our own observations about the market.

Complexity

The FTR product is inherently complex, and when set against a wholesale market which is also complex and volatile, it can be difficult to make meaningful assertions about the performance of the product.

This complexity hands the advantage to the more sophisticated participants who understand how the auction solves and how to profit from auction features. A less sophisticated participant may not be aware of these features or choose not to utilise them.

FTR returns

It is difficult to determine whether FTRs trade below fair value.

A participant can bid in multiple auctions leading up to the FTR month and will bid based on their expectation of the FTR products value. These bids are likely to be aligned with futures pricing at the time of each auction and subject to a discount for the risk of scaling.

With forward market prices that have been steadily firming, spot pricing outcomes following suit and few instances of scaling, the averaging effect of building up a FTR portfolio over number of auctions in a firming market is likely to produce good returns - and may make it appear as though FTRs are trading below fair value.

We would continue to expect that in months with low spot pricing, FTR returns will be low or negative – which is shown to have occurred in figure 65.

Secondary effects

The existence of the FTR market is likely to have added liquidity to the ASX and over-the-counter (OTC) markets. This is beneficial to competition in the electricity market.

A party that holds FTRs may choose to trade ASX contracts or CFDs to hedge the FTR position that they hold. A positive return on the FTR position may be offset by a loss on the ASX or CFD position (and vice-versa). Looking at FTR profitability in isolation neglects the impact of offsetting transactions that are made outside of the FTR market.

Short-term nature

The uncertainty around the quantity of FTRs available in a particular month and their relatively short period of availability¹ makes it difficult to use the product for making long-term investment decisions such as building a new power station or deciding to retail in a certain location (particularly if that location is subject to constraints).

Due to scaling targets the availability of a FTR can be heavily reduced for the months in which transmission outages impact on the FTRs transmission path. This results in FTR availability being low in the months where they are most likely to be needed.

For these reasons physical transmission capacity is the key consideration to a generation investment decision.

FTR locations

The initial two-node FTR market (Benmore and Otahuhu) allowed for the management of inter-island price risk. This meant South Island generators could retail in the North Island with more confidence (and vice-versa). This had significant benefits for retail competition as it allowed for the hedging of inter-island constraints.

Some FTR nodes that have been added since the initial two-node FTR market have been set up at nodes that have tended to favour FTR capacity over locational price risk.

An example of this is the Redclyffe FTR, which is located on the 220 kV Redclyffe pricing node. The FTR does not act as a hedge for transmission constraints that cause elevated

¹ Up to two years ahead of the current month.

prices on the 110 kV part of the Hawkes Bay and Gisborne grid. However, it is useful for hedging against export and import constraints that occur in the Wairakei ring.

If there is anything in our response that you wish to discuss further, please feel free to contact me.

Yours sincerely,



Nigel East
Forward Markets Manager