Genesis Energy Limited
155 Fanshawe Street
Auckland 1010
New Zealand

T. 09 580 2094

6 July 2022

Submissions
Electricity Authority
PO Box 10041
WELLINGTON 6143

By email: wholesaleconsultation@ea.govt.nz

Financial Transmission Rights - Market Observations

Genesis Energy Limited (**Genesis**) welcomes the opportunity to provide feedback on the Electricity Authority's (**Authority**) consultation paper: *Financial Transmission Rights: Market Observations* dated May 2022.

The fundamental purpose of the FTR market is to provide a cost effective means for those with locational price risk (**LPR**) to manage that risk.

It is encouraging to see that the Authority's analysis of the FTR market and its founding objectives, confirms a number of the concerns that we raised with the Authority in 2020. These included speculators in the FTR market, who bear no locational price risk (**LPR**), profiting from their speculation, with a resulting wealth transfer from transmission customers to these parties.

While the FTR market was intended for participants with LPR to manage, participants who do not face locational price risk have acquired FTRs in large volumes as a speculative profit-oriented play. In some instances, more than half of available FTRs were acquired. This speculation limits the use of FTRs as a cost effective risk management option for participants with LPR, and there is no evidence that speculators provided the liquidity and other benefits which the Authority had assumed in permitting their participation in the market. The effective cornering of the FTR market, and its impact on FTRs as a risk management option, threatens the utility of FTRs and ultimately, confidence in the FTR market. At the same time, the costs of supporting the FTR market through LCE amounts have increased more than five fold from $0.77m per month in 2013 to $5.29m currently.[1]

The Authority's 2019 post-implementation review of the FTR market[2] indicated that the market was not achieving its objectives. This is now evident and the Authority's observations in the consultation paper reflect this. Put simply, the FTR market benefits

[1] FTR - Market Observations Consultation Paper, May 2022 at p. 24.
[2] Post implementation review of the FTR Market, November 2019 at 10.40 - 10.42 (https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/).

speculators not FTR participants with LPR or consumers. We don't believe that the current FTR market settings will resolve these issues.

Genesis considers that the critical first steps to addressing the issues with the FTR market are to:

(a) cap the total amount of FTRs that can be acquired by a party (whether directly or through an agent) in any FTR auction to the percentage that their spot purchase volume comprises of the total volume purchased in the spot electricity market in the 12-month period prior to the relevant auction;

(b) where a non-physical financial party is transacting on behalf of a party that bears LPR, require that the identity of that party be disclosed so that transparency in the FTR market is improved and all FTR market participants are treated in a consistent manner;

(c) exclude non-physical financial parties with no LPR from the FTR market; and

(d) introduce a proportionate voting system using the methodology described in paragraph (a) for adding or removing FTR hubs.

We ask that the Authority act swiftly to implement these.

Our detailed response to the Authority's observations in the paper are set out in the Schedule.

Please contact me should you wish to discuss our response further.

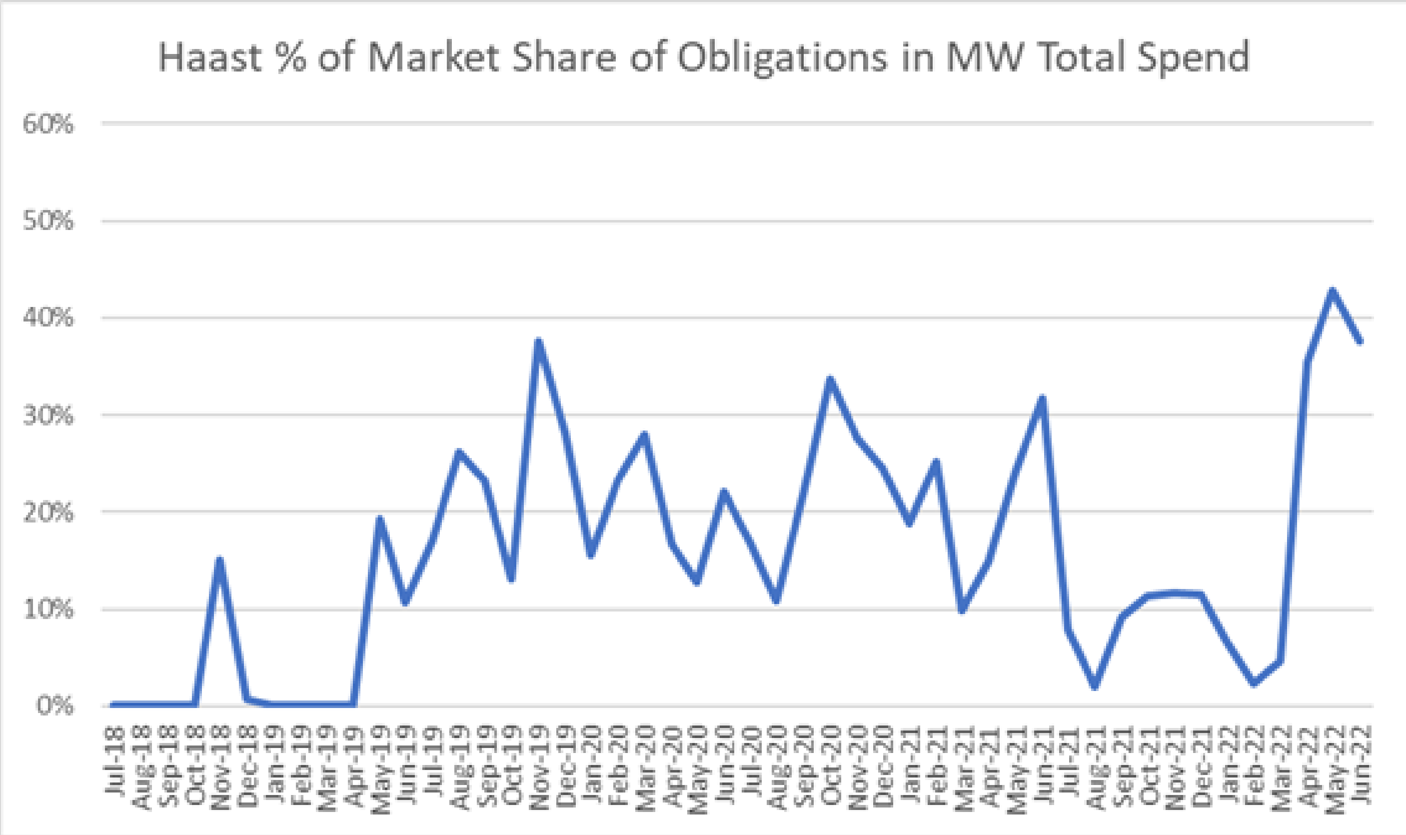
Yours sincerely

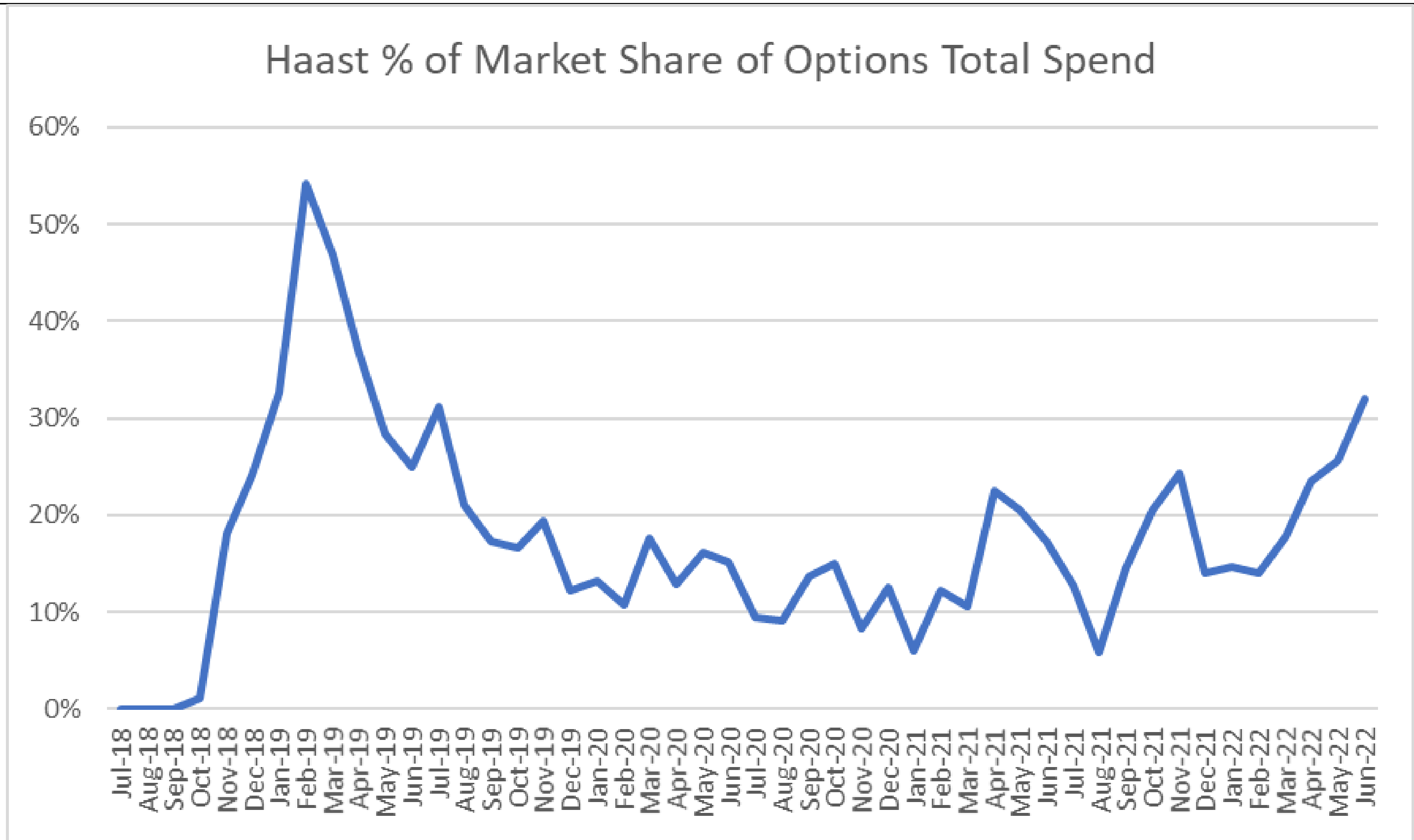
Warwick Williams
Senior Regulatory Counsel and Group Insurance Manager

SCHEDULE

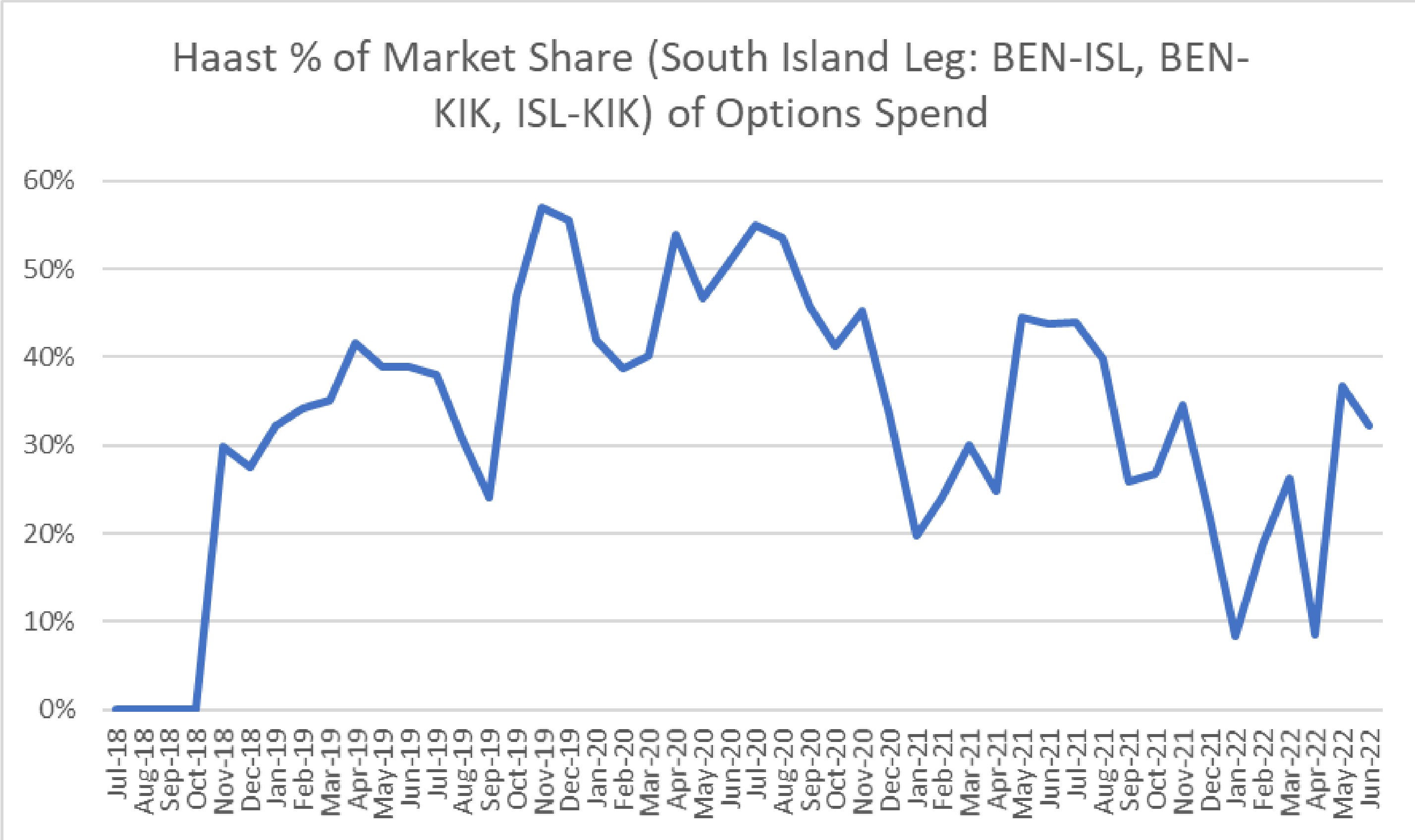
Observation 1: Changes in the make-up of renewable generation will see LPR continue to change over the next 10 years.	
Q1. What is your view on how LPR might evolve over the next decade?	We agree that the nature of LPR may change with the anticipated increase in intermittent renewable generation. However, while there will be new sources of locational risk as these new projects are commissioned, the impact that batteries and demand response services on managing LPR will also need to be considered.
Q2. Do you see LPR as a genuine risk to your business? Why/why not?	Yes. Genesis' retail load spans the entire country, and in many areas, at some distance from our generation.
Observation 2: Retail competition has increased over time, however it is difficult to determine the influence that FTRs have on retail competition.	
Q3. What influence has the availability of FTRs had on your decision to compete for consumers?	Decisions on the extent to which we compete in a particular region are principally driven by our company strategy.
Q4. What benefits do you see the FTR market providing in terms of consumer outcomes? Why/why not?	The fundamental purpose of the FTR market is to provide a cost effective means for those participants with LPR to manage this risk. The value of the FTR market as a risk management tool is significantly diminished if one or more participants with no LPR acquires significant FTR volumes. This has been a frequent occurrence, with Haast Energy Trading (**Haast**) gaining large volumes in each FTR auction despite having no LPR. As we discuss in Q8 below, the FTR market benefits speculators not consumers.

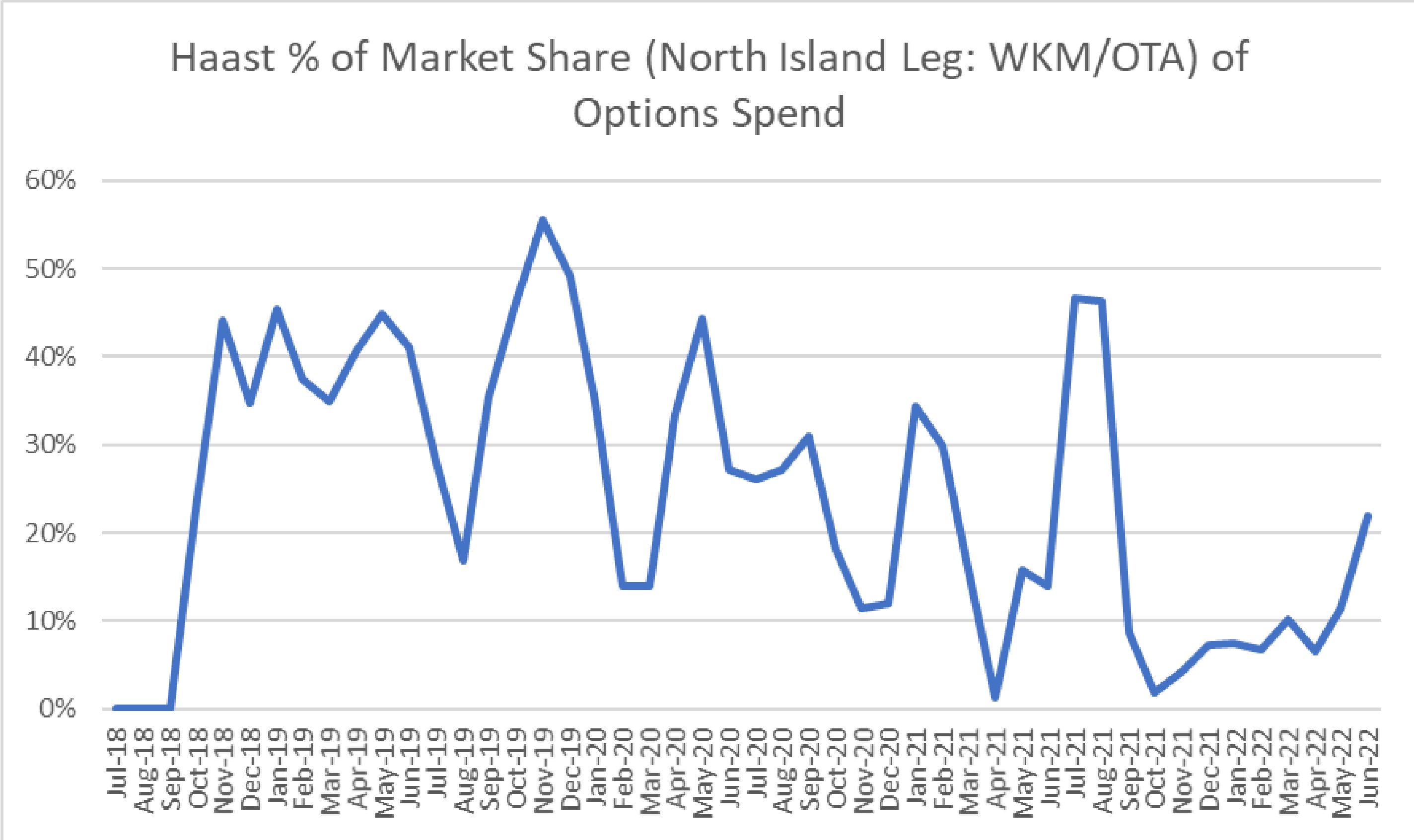
<table>
<tr><td colspan="2">Observation 3: There has been no apparent impact on generator competition due to FTRs.</td></tr>
<tr><td>Q5. What influence has the availability of FTRs had on your generation investment decisions?</td><td>We view FTRs as a risk management tool. FTR availability does not have a significant bearing on our generation investment decisions. These decisions are principally based on our vision of empowering New Zealand’s sustainable future, our objective of growing our renewable generation portfolio, as well as forecast demand and wholesale electricity prices, and proximity to load.</td></tr>
<tr><td>Q6. Has the FTR market allowed your business to build new generation plant in new geographic areas? Why/why not?</td><td>See response to Q5.</td></tr>
<tr><td colspan="2">Observation 4: FTRs currently use an average of $5.29 million per month from LCE (~47% of total LCE) to settle.</td></tr>
<tr><td>Q7. Does the current use of LCE to support the settlement of the FTR market deliver the best outcomes for consumers? Why/why not</td><td>No. See response to Q8.</td></tr>
<tr><td colspan="2">Observation 5: Some parties may be consistently profiting from FTRs without a clear benefit to consumers.</td></tr>
<tr><td>Q8. Why do you think some FTR participants are profiting from</td><td>The fundamental purpose of the FTR market is to provide a cost effective means for those with LPR to manage this risk. However, the value of the FTR market is significantly diminished if one or more participants with no locational risk to hedge corners the supply of FTRs. As shown in the charts below based on FTR registry information, Haast</td></tr>
</table>

FTRs more than others?	has consistently acquired a significant proportion of FTRs – at times, well over 50% of available FTRs, raising the prospect of whether the FTR market is fit for purpose.
	

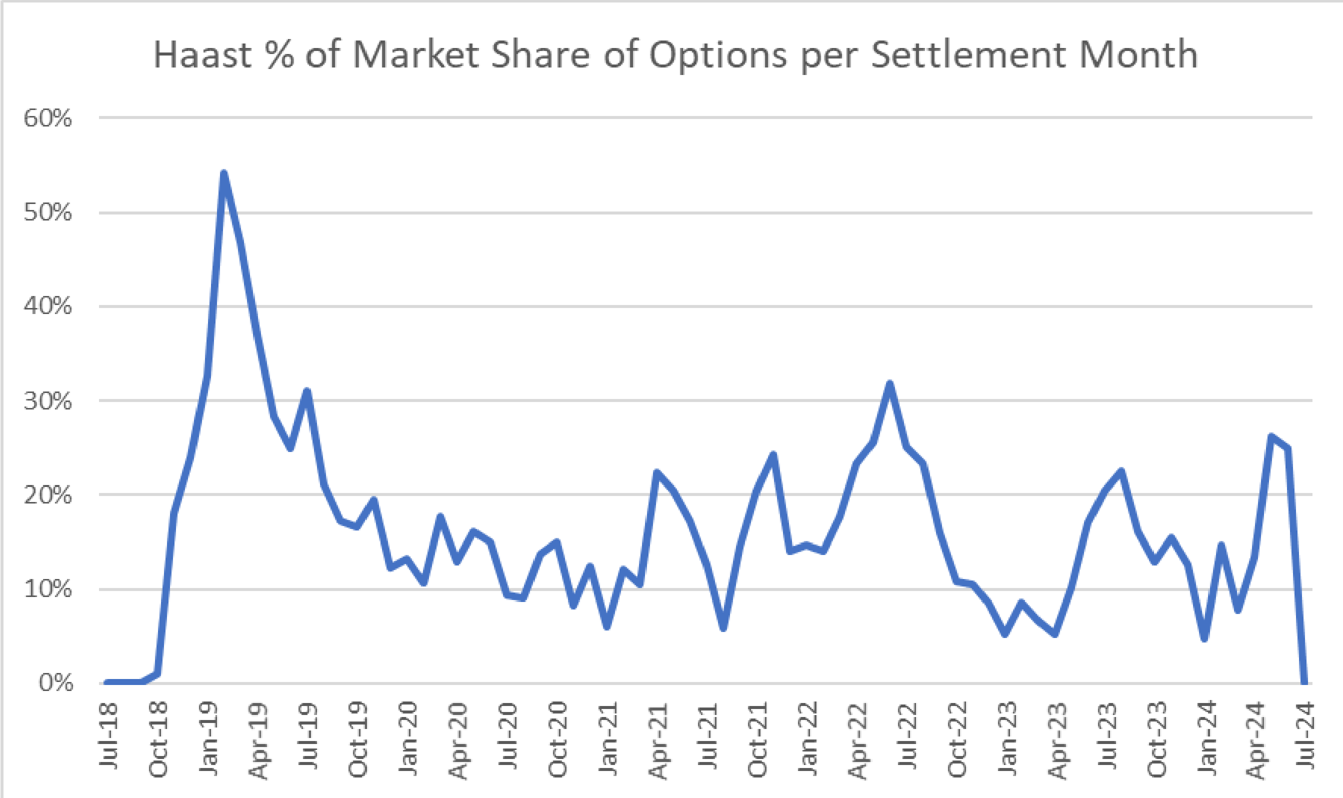


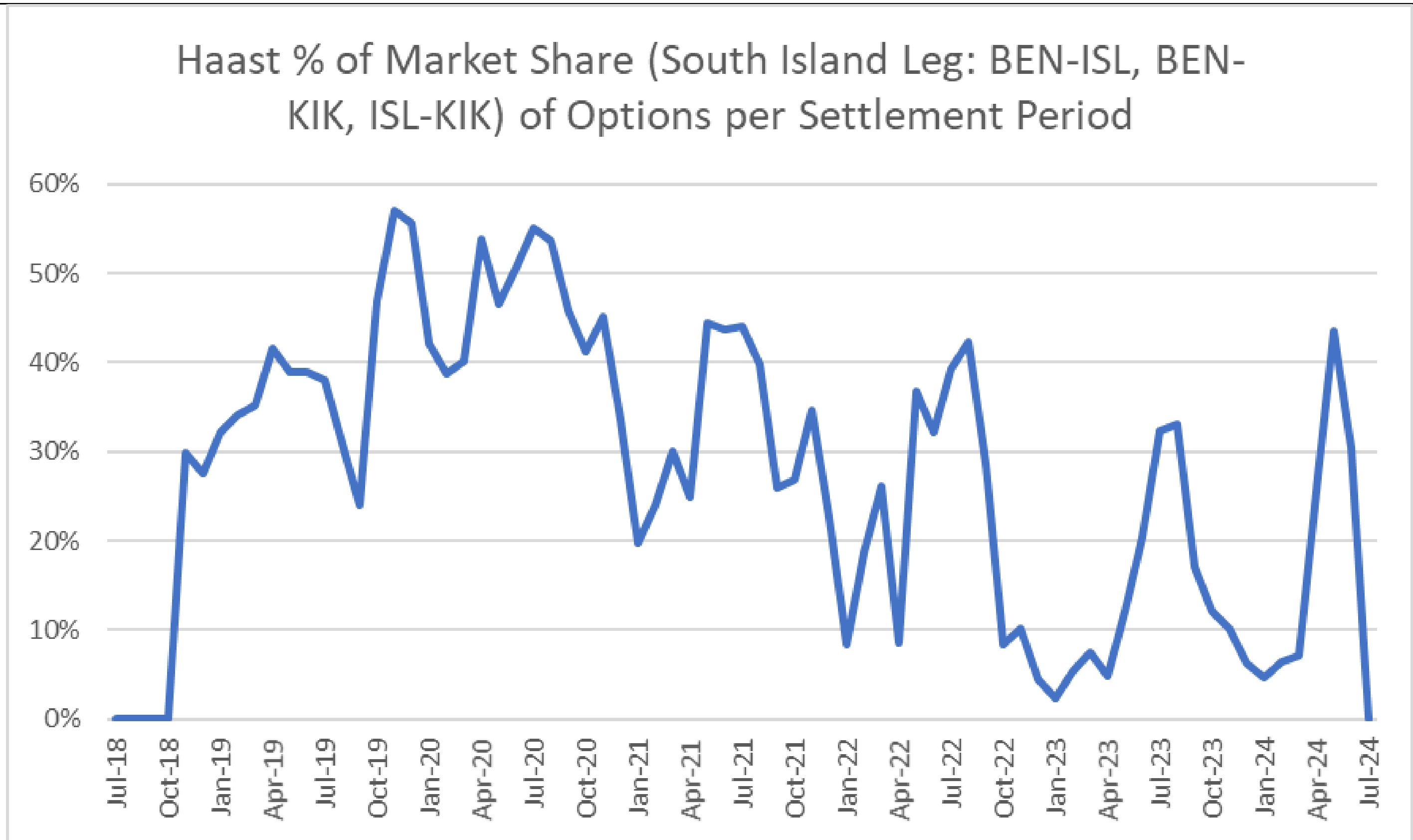
Haast % of Market Share of Options Total Spend
60%
50%
40%
30%
20%
10%
0%
Jul-18
Aug-18
Sep-18
Oct-18
Nov-18
Dec-18
Jan-19
Feb-19
Mar-19
Apr-19
May-19
Jun-19
Jul-19
Aug-19
Sep-19
Oct-19
Nov-19
Dec-19
Jan-20
Feb-20
Mar-20
Apr-20
May-20
Jun-20
Jul-20
Aug-20
Sep-20
Oct-20
Nov-20
Dec-20
Jan-21
Feb-21
Mar-21
Apr-21
May-21
Jun-21
Jul-21
Aug-21
Sep-21
Oct-21
Nov-21
Dec-21
Jan-22
Feb-22
Mar-22
Apr-22
May-22
Jun-22

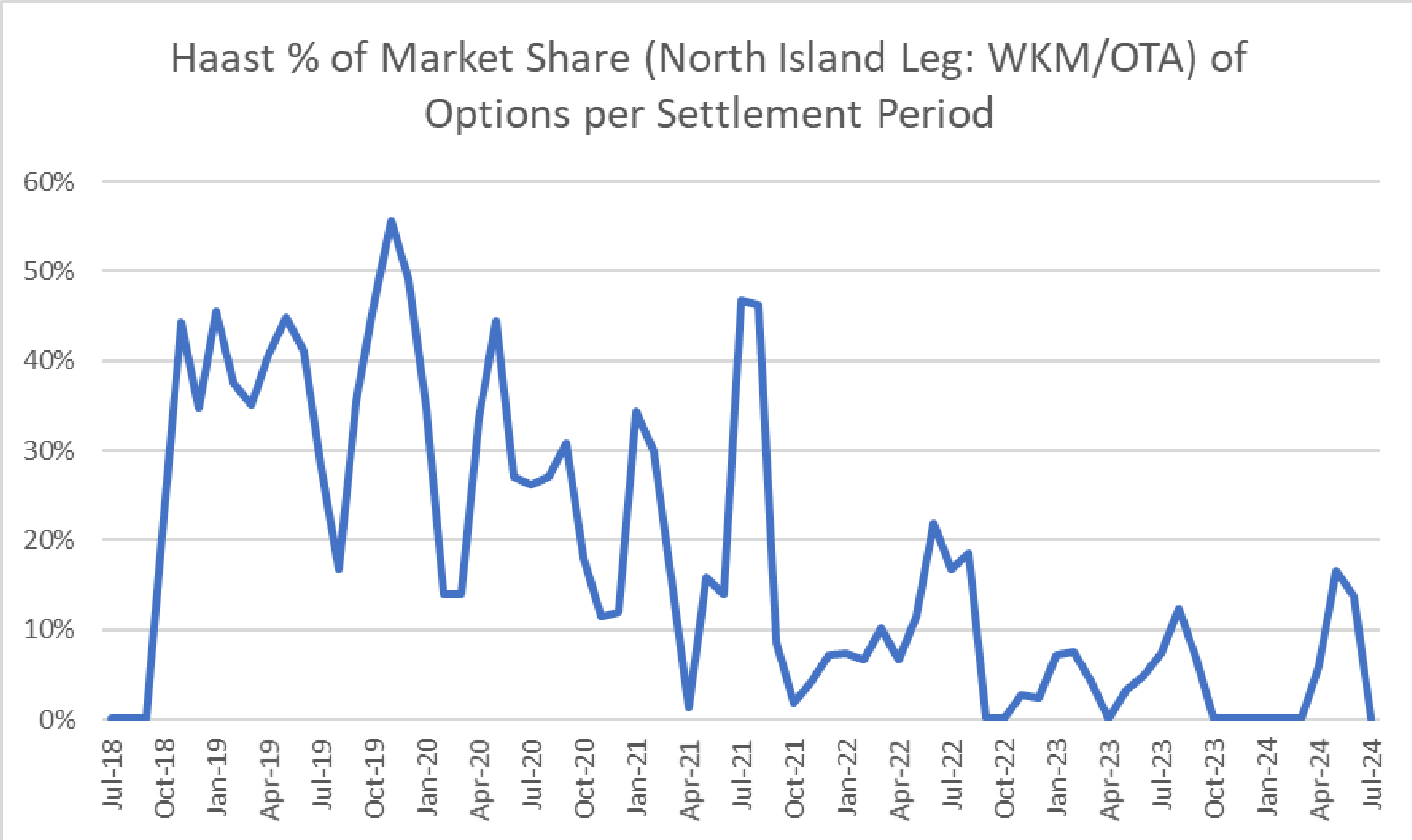

Haast % of Market Share (South Island Leg: BEN-ISL, BEN-KIK, ISL-KIK) of Options Spend
60%
50%
40%
30%
20%
10%
0%
Jul-18
Aug-18
Sep-18
Oct-18
Nov-18
Dec-18
Jan-19
Feb-19
Mar-19
Apr-19
May-19
Jun-19
Jul-19
Aug-19
Sep-19
Oct-19
Nov-19
Dec-19
Jan-20
Feb-20
Mar-20
Apr-20
May-20
Jun-20
Jul-20
Aug-20
Sep-20
Oct-20
Nov-20
Dec-20
Jan-21
Feb-21
Mar-21
Apr-21
May-21
Jun-21
Jul-21
Aug-21
Sep-21
Oct-21
Nov-21
Dec-21
Jan-22
Feb-22
Mar-22
Apr-22
May-22
Jun-22



Haast % of Market Share (North Island Leg: WKM/OTA) of Options Spend
60%
50%
40%
30%
20%
10%
0%
Jul-18
Aug-18
Sep-18
Oct-18
Nov-18
Dec-18
Jan-19
Feb-19
Mar-19
Apr-19
May-19
Jun-19
Jul-19
Aug-19
Sep-19
Oct-19
Nov-19
Dec-19
Jan-20
Feb-20
Mar-20
Apr-20
May-20
Jun-20
Jul-20
Aug-20
Sep-20
Oct-20
Nov-20
Dec-20
Jan-21
Feb-21
Mar-21
Apr-21
May-21
Jun-21
Jul-21
Aug-21
Sep-21
Oct-21
Nov-21
Dec-21
Jan-22
Feb-22
Mar-22
Apr-22
May-22
Jun-22


Haast % of Market Share of Options per Settlement Month
60%
50%
40%
30%
20%
10%
0%
Jul-18
Oct-18
Jan-19
Apr-19
Jul-19
Oct-19
Jan-20
Apr-20
Jul-20
Oct-20
Jan-21
Apr-21
Jul-21
Oct-21
Jan-22
Apr-22
Jul-22
Oct-22
Jan-23
Apr-23
Jul-23
Oct-23
Jan-24
Apr-24
Jul-24


Haast % of Market Share (South Island Leg: BEN-ISL, BEN-KIK, ISL-KIK) of Options per Settlement Period
60%
50%
40%
30%
20%
10%
0%
Jul-18
Oct-18
Jan-19
Apr-19
Jul-19
Oct-19
Jan-20
Apr-20
Jul-20
Oct-20
Jan-21
Apr-21
Jul-21
Oct-21
Jan-22
Apr-22
Jul-22
Oct-22
Jan-23
Apr-23
Jul-23
Oct-23
Jan-24
Apr-24
Jul-24



This evidence is consistent with the findings of the Authority's 2019 post implementation review of the FTR market. The review identified that FTR products sometimes trade at auctions at prices far higher than they settle which allows those who have cornered the market for these FTRs to "make significant profits from time to time".[3]

At the time, the Authority regarded this trading behaviour as "astute" rather than problematic or anti-competitive, stating that:[4]

> *This enables astute traders to make significant profits from time to time, which may lead to accusations that the FTR market merely exists as a money-making scheme for speculators who have no presence in the physical electricity market.*
>
> *But in fact, such trading activity serves a market making role, likely increasing the liquidity of the FTR market, since it increases the likelihood that physical participants will be able to adjust their FTR holdings at a reasonable price as their circumstances change.*

The Authority in this consultation notes the persistent profitability of FTRs and makes a similar assertion:

> *"The Authority also expects improvements to FTR price discovery are aided by speculators participating in the FTR market."*[5]

Genesis does not believe that these touted benefits of speculators have transpired.

In our view:

(a) Speculative activity can be a useful for liquidity and price discovery in mature markets. But such activity with the issues described above, in a nascent FTR market, hinders rather than furthers the objectives of establishing the FTR market. The accumulation of FTRs by speculators with no LPR adversely impacts the ability of retailers

---

[3] Post implementation review of the FTR Market, November 2019 at 10.40 - 10.42 (https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/).

[4] Ibid.

[5] FTR - Market Observations Consultation Paper, May 2022 at pp. 30 and 35.

	and others to manage their LPR by reducing the cost effective options available to them. This ultimately leads to higher hedging costs being passed onto customers. Speculative trading of FTRs, whilst profitable for skilled actors, does not improve the competitiveness of the wholesale or retail electricity markets, or the end consumer. (b) We have not seen evidence of speculators improving FTR liquidity or price discovery: (i) Given that the FTR procurement process is via an auction for a fixed supply – more participants reduce the available FTR capacity for existing ones, rather than increase it. Further, there has been no significant FTR trading activity and no improvement to FTR liquidity that we can observe. The only benefit of speculators would be if they were to actively trade FTRs on a secondary market. But this is not the case. There have only been a few occasions where FTRs have traded outside of the auctions, or where we have seen capacity sold back in a subsequent auction. Moreover, it is reasonable to expect that participants holding a surplus of FTRs would be reluctant to on sell them at acceptable prices in circumstances where retailers would be seeking cover at short notice (for example, in response to unexpected transmission outages or other supply disruptions). (ii) The extent to which speculators facilitate price discovery in practice is highly questionable given the large volumes purchased by a few parties, the absence of secondary trading and the dearth of participants with LPR using the market. In any event, price discovery should be facilitated by those participants who bear LPR rather than speculators. (c) As the Authority acknowledges, the speculation by non-physical financial participants has resulted in a wealth transfer from transmission customers (which are exposed to LPR and / or use LCE payments to offset their costs of participating in the physical market) to parties who bear no LPR.[6] The Authority's analysis shows the average amount of LCE required to support the FTR market has increased significantly from $0.77m per month to $5.29m per month. Accordingly, not only has the FTR market become over five times more expensive to support and not achieved its founding objectives, the amount of LCE is being siphoned off by speculators

[6] FTR - Market Observations Consultation Paper, May 2022 at p 34.

	has also increased significantly. It is difficult to see how the significant costs and the LCE leakage to speculators with no LPR, are desirable or in the long-term interests of consumers. (d) The Authority considers that if there were fewer FTR participants, this may be inefficient as it would result in a greater share of LCE being used to support the FTR market.[7] It is not clear that this would necessarily be the result. Even if this were the case, we question this conclusion as the LCE remains within the system to offset purchase costs, instead of leaving the system through speculators. Unlike other risk management products such as ASX listed NZ electricity futures, FTRs are partially funded by participants in the physical market through the LCE. The FTR market was not intended to allow this capital to be siphoned off by speculators, particularly where there has been no demonstrable benefit from their participation. (e) Adding new FTR hubs with comparatively little retail load such as Kikawa in the South Island and Bream Bay in the upper North Island, are only useful for speculation and exacerbate the issues discussed above. Under the current FTR framework, FTR participants have one vote each. As non-physical participants with no LPR currently outnumber FTR participants with LPR, they have the ability to approve additional hubs that benefit speculators rather than parties seeking to manage LPR. They have no incentive to do otherwise. Consequently, while this FTR market governance issue was not raised by the Authority in the consultation paper, we ask that the voting framework be amended so that those participants who have LPR to manage are given appropriately weighted voting rights. We propose a proportional voting framework where voting rights are weighted in accordance with their share of the spot purchase market over the 12-month period prior to the vote. The Authority's 2019 post-implementation review of the FTR market[8] indicated that the market was not achieving its objectives. This is now evident and the Authority's observations in the consultation paper reflect this. Put simply,

[7] FTR - Market Observations Consultation Paper, May 2022 at p 30.
[8] Post implementation review of the FTR Market, November 2019 at 10.40 - 10.42 (https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/).

	the FTR market benefits speculators not participants with LPR or consumers. We do not believe that the current FTR market settings will resolve these issues. Genesis considers that the critical first steps to address the above issues would be to: (a) cap the total amount of FTRs that can be acquired by a party (whether directly or through an agent) in any FTR auction to the percentage that their spot purchase volume comprises of the total volume purchased in the spot electricity market in the 12-month period prior to the relevant auction; (b) require, where a non-physical financial party is transacting on behalf of a party that bears LPR, that the identity of the principal be disclosed so that transparency in the FTR market is improved and all FTR market participants are treated in a consistent manner; (c) exclude non-physical financial parties with no LPR from the FTR market; and (d) introduce a proportionate voting system using the methodology described in (a) for adding or removing FTR hubs.
Observation 6: The LPR due to losses is highly correlated with energy prices while LPR due to constraints is not.	
Q9. Is it for the benefit of consumers to use loss rentals, constraint rentals and auction income to support the settlement of the FTR market? Why/why not?	If speculation by parties with no LPR continues (with the resulting leakage of LCE) as described in our response to Q8, no.

Observation 7: Many parties (particularly direct connect consumers and independent retailers) who are subject to LPR are not using the FTR market.	
Q10. Why do you think organisations that are exposed to LPR are not participating in the FTR market (directly or indirectly)?	We expect that many of the concerns raised in the 2017 UMR survey of market participants on the FTR market remain. We ask that the Authority commission a similar survey to confirm.
Q11. What do you think can be done to maximise the efficient use of LCE for the benefit of consumers?	For the reasons set out in Q8, participation in the FTR market should be limited to physical market participants with LPR exposure.
Q12. Do you consider LPR to be an impediment to effective retail and generation competition? Why/why not?	Yes, to the extent that LCE leakage continues to grow as discussed in Q8 above, and participation in the FTR market by those with LPR remains limited.
Q13. How does the FTR market allow you to manage LPR? What non-FTR market tools do you use to manage LPR?	An effective and efficient FTR market would provide a useful tool in addition to other risk management tools that we use such as NZ electricity futures and OTC derivative contracts.

Q14. Are changes required to the FTR market for the long-term benefit of consumers? Why/why not?	Yes – see response to Q8.
Observation 8: FTRs tend to trade somewhat below 'fair value.'	
Q15. Do you agree with the view that FTRs are currently traded below 'fair value'? If yes, why do they trade below fair value?	See our response to Q8.
Q16. Should FTRs be traded at/closer to 'fair value?'	See our response to Q8.
Observation 9: Some features of the FTR market appear to be unintended and have no direct link to consumer benefit.	
Q17. Are there other features of the FTR market that appear unintended or to have no clear consumer benefit?	See response to Q8, including the current FTR voting framework.

Q18. Does the feature of the FTR market identified by the Authority negatively impact consumers? How?	We agree with the Authority's observation that is difficult to see how the FTR market in its current form, and which is becoming increasingly expensive to support, contributes to the long-term benefit of consumers.[9] See further our response to Q8.
Observation 10: The Financial Markets Authority does not regulate trading conduct in the FTR market.	
Q19. Do you think there is a requirement for enhanced oversight of the FTR market?	Yes.
Observation 11: Revenue adequacy settings of the FTR market contribute to the profitability of FTRs.	
Q20. What are your views on speculators benefiting from the design of the FTR market?	This is an unintended outcome. The FTR market, in its current form, benefits speculators not the parties with LPR to manage. See our response to Q8.
Q21. What benefit does speculation provide to the FTR market, and what link	None. See our response to Q8.

[9] FTR - Market Observations Consultation Paper, May 2022 at p. 29.

does this provide to consumer benefit?	