Meridian.

4 July 2022

Financial Transmission Rights issues paper
Electricity Authority

By email: WholesaleConsultation@ea.govt.nz

Financial Transmission Rights issues paper – ensuring arrangements are fit-for-purpose

Meridian appreciates the opportunity to provide feedback to the Electricity Authority on their set of market observations relating to the Financial Transmission Rights (FTR) market.

General comments

The FTR market plays a valuable role for market participants, such as Meridian, to manage our locational price risk (LPR). As a nationwide retailer, with predominantly South Island based generation assets, this has been a useful way for us to manage the nodal price risk that arises from having retail commitments in different locations to our generation base.

However, in our view the FTR market is not working as intended. We think that there are potentially significant costs to New Zealand consumers. We support the Authority's work to review the FTR market, and we would like to see improvements made as soon as possible.

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Our comments on the Authority's market observations

We have grouped our comments around the market observations set out in the issues paper.

Observation 1: Changes in the make-up of renewable generation will see LPR continue to change over the next ten years

Meridian agrees that increasing reliance on intermittent generation (such as wind and solar) could change the nature and scope of LPR as New Zealand decarbonises. It seems clear that nodal prices will become increasingly volatile, and that the broad pattern of power flows between South and North alter and become more variable within days/weeks/months. In Meridian's view, products such as FTRs will become increasingly important in enabling market participants to manage their risk.

Observation 2: retail competition has increased over time, however it is difficult to determine the influence that FTRs have on retail competition

Meridian's view is that the chosen node for examination (Redclyffe) is not a good representative view of the impact that the FTR market has had on retail competition. This is partly because the RDF2201 node is on the wrong side of a regular transmission constraint (the interconnecting transformers at Redclyffe), therefore it is not useful for hedging Hawkes Bay LPR.

A more suitable node for investigation would be one that is traded more heavily, such as Whakamaru or Otahuhu. We expect that this would give a more realistic picture around the issue of whether the FTR market has expanded retail competition. Our view is that the FTR market has improved participants ability to compete in these regions. The availability of FTRs has also provided our business with a practical way to manage our LPR.

Observation 3: there has been no discernible effect on regional generator competition due to FTRs

Meridian's experience is that the location of our physical generation investments is influenced by a wide variety of factors, including where renewable resources are located, access to land and transmission infrastructure, and likelihood of gaining resource consent. We think that it is unlikely that renewable generators would base their investments around

FTRs. We note also that there is a mismatch between the timing of generation investments (which are typically developed according to a 20-30 year investment timeframe) and FTRs, which are only available in two year increments. As generation investments are developed for an expected return over longer timeframes, it is reasonable to assume that the availability of FTRs would be of a lesser influence than other factors.

Observation 4: FTRs currently use an average of $5.29m per month from LCE (~47% of total LCE) to settle

This is a key observation and indicates the increasing scale of potential consumer costs to fund the FTR market. The more LCE that is allocated to settle FTR's, the less that is retained within the physical power system and allocated to transmission customers and end consumers.[1]

In order for the FTR market to deliver net benefits to consumers, the benefits associated with the FTR market need to be greater than the cost in terms of lost LCE.

Observation 5: some parties may be consistently profiting from FTRs without a clear benefit to consumers

What the Authority has observed here has been of concern to Meridian for several years. There is considerable speculation on the FTR market by non-physical financial traders, many based in other jurisdictions (speculators make up around 50% of the market). As the issues paper notes, the FTR market was set up for electricity market participants to manage their LPR, and thereby reduce the cost of providing electricity to New Zealand consumers. However, very high levels of FTR trading by non-physical participants raise real doubts as to whether New Zealand consumers benefit from the FTR market, as it is currently designed.

As the FTR market is auction based with limited volumes available, speculators provide no additional liquidity to the market. Instead, speculators reduce the number of FTRs available for physical participants to use to manage their locational risk.

[1] Subject to Electricity Authority decisions on how to allocate residual LCE.

As shown in the table below, over the four financial years 2017-2021 $230.3m from the LCE pool was used to settle the FTR market.[2]

FTR market FY 17-21 (to end June)	
FTR Auction income	$571,371,085
FTR Payments	$801,681,518
LCE used to settle FTRs	**$230,310,432**

Over this time, of the $230.3m of LCE used to settle FTRs, $94.8m (41%) was allocated to non-physical participants. The value of LCE used to settle FTRs is also the profit made by these participants (as it is the amount left after taking away the FTR auction purchase costs). Below is a list of non-physical participants along with the revenue they have derived from LCE over the 2017-2021 financial years.

Participant	Total revenue from LCE (FY17-FY21 to end June)
Haast Energy Trading	$42,701,989
Macquarie Group	$2,888,735
MMAE	$906,086
OMFM*	$48,024,436
Smartwin Energy Trading	$308,683
Total	**$94,829,928**

* Note that OMFM may act for a mixture of physical and non-physical participants. This may also be the case for Haast (and possibly others). However, the volume of FTRs transacted by Haast appears to far outweigh any need that their related company, Electric Kiwi, might have for physical hedges.

[2] The data set used does not include December 2019 data due to data quality issues associated with the UTS and changes made to final prices.

Meridian's view is that the current FTR market speculation is not working in the best interests of consumers. Speculation in the market drives up the cost of FTRs and therefore limits the ability of physical participants to manage their locational risk.

Meridian believes that it is unrealistic to expect that the FTR market will converge over time on a price where on average FTR settlements approximate the price paid at FTR auctions. This trend has not been observed in the FTR market to date. Our view is that the Authority should consider making changes to limit the participation of speculators in the FTR market, which will bring the operation of the market back to its intended purpose, which is to manage LPR and therefore drive competitive markets that operate in the best interests of consumers.

Observation 6: the LPR due to losses is highly correlated with energy prices while LPR due to constraints is not

Meridian agrees with the Authority's finding that constraints provide the main source of LPR, as demonstrated by the very limited correlation (about 1%) between constraint rentals and energy prices over 2013-2021.

Observation 7: many parties (particularly direct connect consumers and independent retailers) who are subject to LPR are not using the FTR market

Meridian agrees with the Authority's assessment, based on feedback from electricity industry participants, that the FTR market is complex. We would welcome efforts by the Authority to address this barrier as part of the next phase of work on the operation of the FTR market.

Observation 8: FTRs tend to trade somewhat below "fair value"

Meridian would note that this feature of the market appears to be by design. The inadequacy target (FTRs should be inadequate 1 month out of 12 and the annual average scaling factor target is set at 98%) requires that all LCE and all acquisition costs are insufficient to pay out all FTRs fully. This runs counter to any goal of FTRs not consuming too much LCE on average/trading at "fair value". If prices increase, less LCE is needed, thus the chance of inadequacy decreases, moving away from the target.

Observation 9: some features of the FTR market appear to be unintended and have no link to consumer benefit

Meridian questions the relevance of the example of reverse direction FTRs, given that trading of FTRs outside of auctions is insignificant in scale.

Although there are issues with the market, it still provides a very practical way for national retailers to cover their locational price risk. With improvements, we think that the FTR would work to support healthy competition across New Zealand, for the benefit of consumers.

Observation 10: the Financial Markets Authority doesn't regulate trading conduct of the FTR market

Given the barriers to entry for physical market participants, Meridian questions whether increasing the regulatory burden by bringing it within the ambit of the FMA may exacerbate this problem.

Observation 11: revenue adequacy settings of the FTR market contribute to the profitability of FTRs

Meridian notes the Authority's original decision to allow for speculators to participate in the FTR market. Meridian questions whether this is in the best interests of consumers.

Please contact me if you have any queries regarding this submission.

Nāku noa, nā

Evealyn Whittington
Senior Regulatory Specialist

Meridian's answers to the questions raised in the consultation

	Question	Meridian's view
1	What is your view on how LPR might evolve over the next decade?	Increasing amounts of renewable generation will make the FTR market even more important as a tool for industry participants to hedge their LPR. The flow of electricity and therefore LPR in both directions along many lines would increase due to more intermittent generation. In addition, as FTR pay-outs are a function of both the flow and the price level, with more volatile price levels it is likely that LPR will rise.
2	Do you see LPR as a genuine risk to your business? Why/why not?	Yes. As a nationwide retailer, with a physical generation asset base primarily located in the South Island, this is a feature of our business environment.
3	What influence has the availability of FTRs had on your decision to compete for customers?	The FTR market is a critical component to enable us to operate as a nationwide retailer.
4	What benefits do you see the FTR market providing in terms of customers? Why/why not?	Our view is that products that allow physical participants to hedge their LPR will overall flow through to stable and efficient pricing for consumers.
5	What influence has the availability of FTRs had on your generation investments?	It has had limited/no influence on our generation investments due to the relatively short-term nature of FTR's compared with generation investment.
6	Has the FTR market allowed your business to build new generation plant in new geographic areas? Why/why not?	LPR is a second order risk and FTRs aren't available in the appropriate timeframe for investment.
7	Does the current use of LCE to support the settlement of the FTR	Meridian's view is that the increasing proportions of LCE necessary to settle the

	market deliver the best outcomes for consumers? Why/why not?	FTR market may not be in the best interests of consumers.
8	Why do you think some FTR participants are profiteering from FTRs more than others?	Meridian's view is that this comes down to the purpose for trading. The core business of electricity companies in New Zealand is generating and selling electricity. Physical participants are therefore likely to be motivated by a desire to manage locational risk in the physical market, whereas sophisticated financial traders are likely to be profit driven.
9	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?	The FTR market would likely operate more efficiently, and consumers would be better off if the bulk of the funding came from auction revenue.
10	Why do you think organisations that are exposed to LPR are not participating in the FTR market (directly or indirectly)?	Likely to be the complexity of operating in the FTR market. FTRs are also likely to be considered by some to be an imperfect risk management tool because of the inadequacy target.
11	What do you think can be done to maximise the efficient use of LCE for the benefit of consumers?	Meridian's view is that the role of speculative traders in the FTR market could be limited, to ensure that LCE is not removed from the market and is instead returned to transmission customers and end consumers.
12	Do you consider LPR to be an impediment to effective retail and generation competition? Why/why not?	LPR is not an impediment to effective retail and generation competition. Nodal pricing is a strength of the New Zealand market and LPR simply reflects the realities of the physical grid. Participants in the New Zealand market are accustomed to managing LPR using a range of tools.
13	How does the FTR market allow you to manage LPR? What non-	Meridian uses the FTR market, along with other tools, to manage its LPR. Other tools include, ASX futures, OTC contracts, retail

	FTR market tools do you use to manage LPR?	pricing, portfolio and investment planning, and LCE payments as a transmission customer (particularly in respect of the HVDC link, although this will end under the new TPM from 1 April 2023).
14	Are changes required to the FTR market for the long-term benefit of consumers? Why/why not?	Meridian's view is that the FTR market needs to be changed to better protect the interests of consumers, and to align with its original purpose of operating as a tool to manage LPR faced by physical participants in the electricity market.
15	Do you agree with the view that FTRs are currently traded below "fair value"? If yes, why do they trade below fair value?	The inadequacy target (FTRs should be inadequate 1 months out of 12, or that all LCE and all acquisition costs are insufficient to pay out all FTRs fully) runs counter to any goal of FTRs not consuming too much LCE on average/trading at "fair value". If prices increase, less LCE is needed, thus the chance of inadequacy decreases, moving away from the target. Massively increasing the volume of FTRs would decrease the price (moving away from fair value) but would increase the chance of inadequacy.
16	Should FTRs be traded at/closer to "fair value"?	In an ideal world that would be the case.
17	Are there other features of the FTR market that appear unintended or to have no clear consumer benefit?	Meridian has not identified other features at this stage.
18	Does the feature of the FTR market identified by the Authority negatively impact consumers? How?	Meridian's observation is that trading of FTRs outside of the auction process is very limited. It is possible that this feature of the FTR market does not substantially impact on consumers.

19	Do you think there is a requirement for enhance oversight of the FTR market?	Given the current barriers to operating in the FTR market, any increase to the regulatory burden is likely to exacerbate existing issues with access to the FTR market.
20	What are your views on speculators benefiting from the design of the FTR market?	See Meridian's comments in the body of this submission. Speculators remove value from the electricity market, whereas participants use FTRs to manage physical risks and offer more competitive prices to consumers.
21	What benefit does speculation provide to the FTR market, and what link does this provide to consumer benefit?	Meridian's view is that speculation is not benefiting the FTR market or consumers.