

Judy Lu

From: Georgie Herb <Georgie.Herb@boldtrading.com>
Sent: Tuesday, 28 June 2022 5:27 pm
To: Wholesale Consultation
Cc: Trading
Subject: Consultation Paper - Financial Transmission Rights market observations

Kia Ora,

We appreciate the opportunity to provide feedback to the EA on its market observations concerning Financial Transmission Rights (FTRs). We will provide comments against your specific questions where appropriate to us, however we would like to also make a few general observations.

1. Both the EA and the market participants who are concerned about the operation of the FTR market have forgotten to normalise the performance of FTRs over time with respect to the electricity forward curve movements before drawing conclusions from their analysis. Generally what is being shown is that the futures curve has rallied over time, not that the FTRs are systemically inefficient or underpriced. Furthermore, drawing conclusions based on 2020 and 2021 performance is also statistically unwise due to Tiwai Point-related curve movements in 2020 and NZU driven price movements in 2021. These were abnormal years with respect to the change in value of all risk instruments in NZ electricity, let alone FTRs. Accordingly, caution should be used when relying on performance over this period of time to draw conclusions as to the functioning of the market.
2. Rather than allowing market participants to comment on the effect that FTRs have on competition in the retail space we believe that extra weight should be given to the view of the independent retailers in this particular area of consultation. Independent retailers appear to us to be using FTRs for hedging and risk management and if this is what promotes competition in the NZ electricity space, then it should be encouraged in order to achieve long-standing benefits to the consumer. It follows that if access is restricted to these market participants, it may have the effect of reducing competition. The fact that the initial letter to the EA requesting a review appears to have been sent shortly after the first Tiwai-related news was digested by the market also implies that it may have been the volatile market conditions at the time which have triggered this review. We believe great care should be taken in any action which reduces access to FTRs for the market as it may be anti-competitive and to the detriment of the NZ consumer.
3. The last 4 years have been extremely challenging for risk management in NZ electricity. We have seen thermal gas constraints, smelters and carbon pricing all exert influence over price and create challenging conditions for all market participants. This will have been especially challenging for independent retailers without a balance sheet to absorb these price risks to their book. We can see from the public FTR register that independent retailers have used FTRs heavily to manage price risk during all of these scenarios. The strategies deployed by other market participants to manage their own risk can also be clearly seen in the register. Some large participants regularly step back from auctions and refrain from participation at their choice for periods of time. This is their right and must be respected, however market participants must also take responsibility for the choices they have made historically to not participate. Every market participant has the right to choose their level of engagement in FTRs and if there is a competitive advantage to be gained through access then this should be encouraged if we are again to achieve long term benefits for the NZ consumer.
4. It is not the EA or the market's responsibility to instruct market participants how to hedge. There are two very key parts to this observation. Firstly, independent retailers have a right to use risk management products as they see fit. This is the essence of retail competition which the EA should be trying to foster – an encouragement of different approaches. Secondly as you have observed, some market participants do not use

FTRs at all but this should also not be a concern for the EA. The EA's mandate in achieving the best outcome for the customer should be to give every participant the equal right to access FTRs, but whether or not they utilise this right is completely up to each individual entity. There is no right or wrong way for participants to manage their risk and indeed there are many different approaches and products available to be used; this is exactly what gives rise to competition within the market. The corollary of these points is that any attempt to curb access to FTRs or restrict their access could easily end up being anti-competitive and clearly to the detriment of consumers.

Our responses to specific questions where we believe our answers would be relevant follow:

Q8: Why do you think some FTR participants are profiting from FTRs more than others?

In order to answer this question we firstly refer back to interview responses previously given to the EA (found here: <https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/>):

Response 1: "Am I comfortable with the size of the FTR market and the way it is structured at the moment? I think with the new FTR nodes then that will probably be about the limit, otherwise it is just getting too complex for anyone to manage. Even the skilled practitioners are going to have to spend more and more time on it and we don't have any time. So, to allocate more time to something when I can't get a head count to do that, so we would have to find more time somehow or other to do that. Which means we have to build more complex models ourselves. So, you are getting to the point of dilution where it is actually getting to the limit of development."

Response 2: "For me it's more about the complexity of the market and just having the resources within our organisation to do that analysis that is really required to do it some kind of justice. So that is really kind of the big thing. I don't actually think the market is terribly accessible." "So, every time you do an FTR it starts off between two nodes, so the possible combinations in any one month between two nodes are up and down so therefore you have two different combinations. Then you add five and you get 42 different combinations, when you have 8 you have 112 different combinations and they have increased the auction frequency as well to attempt to offer more regular auctions, so people can dip in and out of the market more often. Well what you have actually done is made the thing going from slightly more complex to now quite complex and if I was a small retailer, I would be very scared of competing in that space."

It is clear from what these two responses have communicated here that there may be internal limitations within some organisations making it difficult for them to invest resources into developing adequate trading capacity of FTRs. If an entity cannot service these markets because of their own limitations then it follows that it is probable their performance suffers when compared to other market participants. Many other market participants do in fact invest resources into FTR markets and have had the opportunity to achieve better outcomes than those who do not. This is the essence of competition. A small retailer who decides to reduce their cost of hedging by investing resource into building FTR trading capability may be able to generate a lower cost-to-serve which is clearly in the interests of consumers. It should not be viewed as perverse outcome that all participants do not achieve the same outcomes.

Care must also be given when deciding what 'profiting' actually looks like. When an FTR is bought the owner takes on risk that the unit will devalue or rate-set lower than the purchase price. Spot prices and by extension futures prices are a key input into the pricing of FTRs and so when assessing performance over time these profits must be normalised. By way of example, if one buys an FTR link to hedge retail exposure and it increases in value by a lesser than expected amount if the forward curve rises, have they actually profited? We would argue they have not and that in fact the FTR has lost real value. We encourage the EA to consider this when qualifying on participants 'profits'.

Q15: Do you agree with the view that FTRs are currently traded below 'fair value'? If yes, why do they trade below fair value?

Q16: Should FTRs be traded at/closer to 'fair value'?

We reject the premise that FTRs are currently traded below fair value. When normalised for movements in the underlying electricity price we find that over time FTRs are generally priced quite efficiently. Again we re-iterate that you cannot simply compare the purchase price to the rate-set price of an FTR, you must adjust for movements in the forward electricity curve to measure its true performance. This is the relevant metric because of the ultimate end use of FTRs by participants to reduce their locational pricing risk of their spot exposure.

We also note that the FTR market has matured over time to now include a wide range of participants including generators, retailers and speculators. The presence of speculators is essential for bridging gaps in depth between auctions and maintaining efficiency of price over time.

Q20: What are your view on speculators benefiting from the design of the FTR market?

Q21: What benefit does speculation provide to the FTR market, and what link does this provide to consumer benefit?

Speculators have an important role to play in the FTR market. Firstly as is the case in all markets, capital from speculators is used to bridge gaps between demand and supply of risk products over time. That is, speculators provide immediacy for market participants who need to hedge. Within the NZ FTR market this occurs in three ways.

Firstly, speculators are regularly in contact with independent retailers and provide pricing and execute secondary trades in FTRs at times which suit the independent retailers hedging program. This allows for the retailer not to have to wait for the particular tenor of FTR to appear in the auction window, which may be 6 months or more. To provide this service the speculator takes on warehousing risk and revaluation risk over time as it holds the inventory. In our experience, we find that there are some participants who are much less likely to engage in secondary interests, even when it is clear they have been engaging in the auctions. This is a choice they have made actively not to support a secondary market and we respect their choice, however it does not follow that market disfunction exists when they have chosen not to engage. A notable exception to the market's general ambivalence towards the secondary markets was immediately following the initial advice from NZAS that Tiwai would be closing. Demand appeared from a variety of market participants for links flowing north from Invercargill, which other participants were able to sell them because they held inventory. This is a perfect example of speculation adding value to the market which required immediacy and volume.

Secondly, speculators are more inclined than natural market participants to offer units back into the auctions. This is critical if a particular tranche has been oversold and the FTR manager is required to purchase back the links; it is often speculator units that provide the depth required to return the tenor allocation of units to an adequate state at an acceptable price. If this wasn't the case the likelihood of revenue inadequacy would be much higher. Having extra units offered in the auctions also gives natural participants greater depth at the market price if they choose to buy large volumes of units.

Finally, the auctioning of FTR units to speculators has a flow on effect of increasing liquidity in the futures markets. We have found directly that over time holding FTR units has allowed us to have a greater level of participation in the futures markets and provide more pricing. In fact, we have found that often during times of extreme market stress it is FTRs which have allowed us to provide critical liquidity to participants who need to hedge. During 2018 when market-making became difficult for the regulated market-makers it was speculative capital backed by FTRs which was able to assist in providing pricing support to the market. In this way it is correct to consider the immense value add that extra liquidity in futures products delivers to market participants, and by extension the end consumer – particularly at times of market distress.

Response to Market Participants

<https://www.ea.govt.nz/assets/dms-assets/29/Letter-to-the-requestor-26-November-2021.pdf>

We would like to comment on a few inaccuracies which we have observed within these letters. We are concerned that left unsaid these views may form an incorrect foundation for the EA to conduct its review and consultations. We respect the right of all market participants to express their views and simply present our counter-arguments.

“Trading of FTRs outside of auctions is insignificant in scale”. This statement is not correct. There have been many book sales and secondary FTR transactions executed in the market over the last 5 years and many of these have been of significant size. This can be easily be verified by analysing the registry. It is more accurate to say that wide-ranging market participation in secondary markets is not there yet; but the market does exist. We would love for larger market participants to express more of an interest in trading secondarily however it appears to date they have determined to limit their involvement.

“The extend of speculation in the FTR market should be of concern to the Authority”,...“Haast Energy Trading alone accounts for between 20% and 30% of total FTR volumes”. This statement erroneously conflates speculation with competition. Haast Energy Trading have advised they purchase FTR units primarily to manage the risk of its retailing business, Electric Kiwi. It is entirely reasonable to expect that they would utilise FTRs heavily as a large independent retailer.

“It is our view that these high levels of speculation are of no benefit to the market or to consumers and in fact, these levels of speculation are arguably detrimental. Because the FTR market is auction based, speculators do not add liquidity – FTRs are a finite pool”. Speculators provide value to the auctions by warehousing inventory ready to be released when acute demand appears for them in future auctions, or indeed in secondary markets. We observed high demand for particular FTRs from the market in response to Tiwai Point negotiations and the market was able to provide them units on demand. It is therefore inconsistent to argue that speculation is of no benefit when in this specific example the affected market participants benefited directly from it. As detailed above, speculation in FTRs improves price efficiency and improves depth in both FTRs and in futures contracts.

“In the last four financial years Haast Energy Trading alone has made \$17m from FTRs net of purchase costs, i.e. funded entirely by LCE that would otherwise have been paid to NZ transmission customers and passed on to New Zealand consumers”. It appears to us the relevant point is actually that it appears Haast have been prudently hedging. Firstly, as we have stated – Haast use FTRs to assist hedge their customer base; therefore this value will have been passed on to their customer base. Secondly, this ignores the fact that this period of time involved a secular rally of the price of electricity in NZ. Arguing that an independent retailer should not be allowed to hedge in case they make a return on their hedges is not in the interest of the NZ consumer.

“We have not seen evidence of any “market making” or trading activity leading to increased liquidity. Given that the procurement process is via an auction for a fixed supply – more participants reduce the available FTR capacity for existing ones, rather than increase it. The only benefit of speculators, which we see, is if they were to actively trade FTRs on a secondary market. But this is not the case.” This statement is based on an assumption that all FTRs bought are simply held until maturity when this is not the case. Many are in fact offered back into the auctions which is clear from the summary reports published by the FTR manager after every auction. Many others are traded in secondary markets, most often with independent retailers. We have attempted many times over the years to support a secondary market to improve transparency and price discovery however we have found it very hard to secure any support from the market for this. Instead, we have therefore focussed on bi-lateral relationships with independent retailers and other traders as the primary way to trade units.

Conclusion

In summary, we find the concerns raised by market participants to contain some logical inaccuracies which we have attempted to clarify in our submission. Our primary concern is that if the proponents are successful in their lobbying for change that access to risk management products will decrease, which will reduce retail competition overall. We believe that the FTR market functions adequately and is providing benefits to the consumer in its current form.

We are available on request to discuss further any of these points we have made. Thank you for your consideration.

Regards,
Georgie Herb

Co-Founder and Chief Operating Officer



M: +61 400 756 222

E: georgie.herb@boldtrading.com

www.boldtrading.com