30 June 2022

Tom Georg
Manager Market Policy
Electricity Authority

By e-mail: WholesaleConsultation@ea.govt.nz

“Financial Transmission Rights – Successful product for managing risk”

2degrees, Electric Kiwi, Flick Electric, and Pulse (the independents) support the Electricity Authority adopting “a strategic focus on efficient risk markets”. We agree with the Authority “it is important that participants have access to effective tools to manage LPR” and “The successful development of this [FTR] financial risk management tool is helping the wholesale market mature”.[1]

Equal access to efficient risk management tools will not only “support the transition to a greater share of renewable generation” but also help enable a greater level of competition in both the electricity generation and retail markets.

Similarly, we agree with Dr Batstone’s advice to the Authority that: “The ability of market participants to prudently manage risk is critical to the ability of participants to allocate risk efficiently (the “completeness” of markets for risk). This in turn underpins confidence in the market, efficient investment in resources (generation, storage and demand response), and enables the best trade-off between affordability, security of supply, and environmental outcomes”.[2]

The Authority’s FTR post-implementation review (PIR) in April 2020 “found that overall the FTR market has been successful in increasing competition in the retail electricity market” and “have also allowed several users to underwrite or support other risk management products”.[3] While, as should be expected, different retailers have different risk management strategies, the Authority’s PIR findings are generally consistent with independent retailers experience with use of FTRs via “intermediaries” (who Genesis and Meridian incorrectly and pejoratively characterise as “speculators”).

We also agree with Meridian’s submission that the FTR market is “functioning very well”.[4] Meridian has explained how FTRs “assist wholesale electricity market participants to manage their locational price risk … for example, a non-integrated retailer could manage locational price risk between a location where they have retail customers and another location where they are hedged (generally the Benmore or Otahuhu nodes)”.[5]

[1] https://www.ea.govt.nz/about-us/media-and-publications/market-commentary/market-insights/financial-transmission-rights-successful-product-for-managing-risk/
[2] Dr Stephen Batstone, MDAG – Price Discovery with a 100% Renewables Wholesale Market Wholesale risk management practice trends in the NZ electricity market, and prospects for a high-renewables future, October 2021.
[3] https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/
[4] https://www.ea.govt.nz/assets/dms-assets/22/22196MERI.pdf
[5] Meridian, Request for review of the Financial Transmission Rights (FTR) market, 8 October 2020.

The competition issues raised in the FTR consultation appear to reflect that retail and generation competition, particularly generation competition, has not developed or improved to the extent the Authority may have expected or intended. This is a concern we have consistently raised. Issues with lack of adequate or workable competition are highlighted vividly, for example, by the Authority's UMR survey of market participant perceptions and the initial wholesale market review findings. Various of the independent retailer submissions have detailed market statistics which indicate both the wholesale and retail markets are concentrated or highly concentrated depending on the benchmarks used.

While competition has not yet developed as well as it could or should have, we agree with what the Authority labels its "alternative" proposition that "retail and generation competition would be [even] less competitive without the presence of FTRs, and that the management of LPR through FTRs allows for a lower risk solution to the challenges of competition in a nodal price wholesale market".

The appropriate 'solution' is for the Authority to avoid 'throwing the baby out with the bathwater' and ensure development of hedge and risk management tools, including FTRs, which enable independent and new entrant market participants (in both the retail and generation markets) to manage their wholesale (spot) market risk and compete on a level playing field.

Process issues

The independents consider it regulatory good practice to include cross-submissions as part of consultation processes, including for the initial stages of a review; in particular, where (i) there is potential large financial implications for consumers or market participants; and (ii) the issue is likely to be contentious. We have previously advocated for addition of cross-submissions to MDAG consultation and this resulted in a more robust process and better outcomes. Regardless of whether the Authority decides to add cross-submissions to this stage of the consultation we request that submissions be promptly published on the Authority website.[6]

It would also be useful for the Authority to publish its project plan, including consultation steps (and dates) and other milestones for completion of the FTR review.

Summary of the independents' views

- **We agree with the Authority's post-implementation review finding that "Overall the introduction of the FTR market has been a success".** We do not consider there is any sound reason provided in the consultation paper, or Genesis and Meridian's synchronised letters, for the Authority to resile from the PIR conclusions. We consider that the Genesis and Meridian letters reflect a co-ordinated regulatory strategy to misdirect the Authority and block or thwart the ability of independent retailers to manage their risk and compete.

- **The Authority's focus should be on removing barriers to entry and promoting competition:** The Authority should prioritise – in parallel with the wholesale market review and MDAG 100RE projects – reforms that enable independent suppliers (retail and generators) to manage wholesale market risk (including locational price risk) and compete with incumbents on a level-playing field. One of the principal barriers to competition in the electricity market is the adequacy of hedging and locational risk management tools for independent suppliers.

[6] We requested copies of the submissions made 3 months ago on the commercial market-making Code amendments so we could consider them as part of our response to this consultation, but the submissions have not been released.

- **Spot and locational price risk will increase:** The MDAG 100RE project highlights the prospect that spot market volatility and locational price risk will increase as the wholesale market becomes more dependent on renewable generation, increasing the importance that hedge (locational) risk tools are available to market participants.[7] The prospect that hydro generator market power is likely to increase as New Zealand becomes more reliant on renewable energy should be front and centre of the Authority's mind.

- We agree with the Authority that "… potential new sources of LPR to arise as New Zealand diversifies and invests in different sources of renewable generation. For example, the increase in solar investment taking place in the upper North Island might create new sources of risk between Northland and the rest of the transmission network".

- We similarly also agree with emh Trade that changes occurring in the wider electricity market are likely to increase the value of FTRs: "For example: … "Transmission Pricing Methodology changes that rely on locational price separation (rather than existing RPCD charges) to act as a price signal for investment and demand response. Any increase in reliance on price separation creates additional value for hedge products to manage the risk of that price separation, including more granular FTR products."[8]

- **FTR review should be reoriented:** The independents support the Authority's desire "to understand the potential barriers preventing direct customers and retailers from participating in the FTR market, along with solutions to improve participation". We consider that the initial 11 "observations", and related questions, raised in the FTR consultation are jaundiced. The initial "observations" don't provide a neutral or sound basis for reviewing the FTR market in a way that would best promote the long-term interests of consumers.

- There should be a strong focus on development and evolution of risk management tools in the electricity market, rather than revisiting whether FTRs should exist or regulation should be introduced to limit who can participate in the market.

- The types of questions the Authority should be asking mirror the PJM FTR review e.g. to what extent are FTRs achieving their initial purpose, "[a]re there additional purposes and/or sources of value to the market that FTRs are, or should be, fulfilling or delivering?", and "What other mechanisms … can provide alternative ways to achieve some of these purposes? If such mechanisms exist, can they work alongside each other or as variations to current mechanisms to optimise value to load and other market participants?".

- **Operational enhancements identified by the Authority should be adopted:** The independents support immediate implementation of the operational enhancements to the FTR market the Authority previously consulted on.

- **Management of locational price risk and the methodology Transpower uses to allocate residual LCE are separate issues:** The consultation paper discussion on LCE appears to be based on the assumption FTRs will inevitably be a draw-down on LCE which we do not consider to be a valid assumption.

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[7] The consultation paper states "with increased wind and solar generation, the dominance of hydro-generation is expected to decrease over time" but this contradicts the MDAG 100RE consultation. MDAG detail how the increase in reliance on renewable generation could increase the market power of hydro generators with hydro storage capacity (notably Meridian).

[8] emh Trade, Cost and Benefits of Hub Addition, 16 November 2020.

- We note most submitters in response to the Settlement Residual Allocation Methodology (SRAM) consultation didn't support the Authority suggestion allocation of LCE, that is not used for FTRs, be used in a manner that dampens spot market price volatility. The majority of submissions (11 out of 14 submitters) supported either direct pass-through of the residual LCE to wholesale purchasers or (non-distortionary) reduction of residual charges (again going to load customers only).[9]

- The suggestion that "rebating LCE may provide a partial LPR hedge for transmission customers" [emphasis added] would conflict with the majority of submissions the Authority received on the topic, and would be of no assistance to independent retailers trying to compete or for removal of barriers to competition.

Genesis and Meridian's claims "the FTR market is not working as intended" lack merit

We consider that the Genesis and Meridian letters largely consist of false and misleading information and claims. The letters reflect a co-ordinated regulatory strategy to misdirect the Authority and block or thwart the ability of independent retailers to manage risk and compete.

Genesis objects to Haast and financial institutions (they use the term "speculators") involvement in the FTR market claiming "participants who do not face locational price risk have been acquiring FTRs in considerable volumes. This limits the risk management options available to generator-retailer participants who face this risk". Meridian made similar claims: "the EA has suggested that physical participants should be using the limited number of these instruments more directly to hedge risk. If they are being picked up by speculators, physical participants cannot do that …".

This misunderstands the role financial institutions play in the electricity market and the services they provide to independent suppliers. Genesis and Meridian's claims reflect a simplistic and incorrect supposition that financial institutions involvement is purely speculative, while physical participants involvement is purely for risk management purposes. Genesis and Meridian are also making assumptions about the extent to which different participants are engaging in risk management or speculation without any real basis.

It is unclear how Haast or financial institutions involvement in the FTR market could crowd out Genesis and Meridian's use of FTRs, or how they could "corner" the market supply of FTRs.

Both Genesis and Meridian complain that FTRs are too expensive. Genesis wrote to the Authority claiming, "Experience is that "FTRs … have been unavailable at terms that make them an effective or cost efficient option". Similarly, Meridian claimed: "Although FTRs are a useful risk management tool in theory, in our experience they have been unavailable at terms that make them an effective or cost efficient option".

FTRs cannot be under-priced and overpriced at the same time. The Authority's proposition that "FTRs tend to trade somewhat below 'fair value'" is in diametric conflict with Genesis and Meridian's claims they are too high.

[9] Specifically:

- Electric Kiwi and Haast, Flick, Genesis, MEUG (variation on option D), Meridian, Nova, Transpower and WPI (variation on option D) supported Option D: allocation to WEM purchasers based on wholesale energy purchase volumes.
- Electric Kiwi and Haast (2nd preference), Entrust, Transpower (2nd preference), Unison and Vector supported allocation via the residual even though this was not included in the consultation.
- Only Contact, Mercury and Network Tasman preferred an alternative option.

We consider it reasonable to conclude that if Genesis and Meridian are not obtaining adequate FTRs to manage their locational price risk it is because they aren't prepared to pay the true value of covering price risk. We agree with the Authority "… the best way for physical parties to increase their share of the FTR market, so as to better manage their locational risk, is to increase participation and bid prices in FTR auctions. This will increase prices to closer to value, reduce the LCE used to settle FTRs, and reduce the returns to speculation."

The claims Genesis and Meridian have made raise questions about whether they are using appropriate risk management tools and whether they consider there are cheaper options such as "us[ing] their generation offers to manage transmission constraints". Meridian appears to continue to use its generation offer strategy to manage risk. We agree with the Authority comment in the PIR:

> One reason for this might be that exercising one's market power to prevent constraints from binding is a cheaper alternative (from the participant's perspective) than purchasing FTRs or other hedges. This was effectively Meridian's strategy in the 2 June 2016 Trading Conduct breach.

Other gentailers have been clear they use FTRs for risk management e.g. Mercury has submitted it "will continue to manage pricing risks in the electricity spot market through various mechanisms including other hedge arrangements, trading ASX futures, buying FTRs and the like".[10]

The appropriate 'remedy' may therefore be oriented around the type of market education the Authority has previously discussed[11] and/or on ensuring generators cannot continue to use their physical assets and generation offers to manage locational risk.[12]

The independents agree with the positions held by the Authority in its open letter and post-implementation review

The independent retailers agree with the Authority that greater participation in the FTR market results in higher FTR prices/less reliance on LCE funding:[13]

- "To the extent that Haast's participation (and that of other speculators) has the effect of increasing the price of FTRs to closer to their value (and Figure 2 suggests this is happening), its actions reduce the amount of reallocated LCE. This means less capital "syphoned off" and less profit for speculators. If there were no speculation in the FTR market—or speculation was discouraged—more LCE would be "syphoned off" and the beneficiaries of this would be physical players such as Meridian and Genesis."

- "As with other electricity derivatives such as ASX exchange traded products, there is both the hedging value of the risk management products themselves and the value of the associated forward price curve. For FTRs, speculators can enhance the robustness of the forward price by moving the price paid for FTRs closer to value. Since most of the speculators both buy and sell FTRs, they will also help to increase liquidity."

- "… the best way for physical parties to increase their share of the FTR market, so as to better manage their locational risk, is to increase participation and bid prices in FTR auctions. This will

[10] https://comcom.govt.nz/__data/assets/pdf_file/0031/261859/Mercury-NZ-Limited-and-Trustpower-Limited-Clearance-application-30-July-2021.pdf

[11] The FTR PIR suggested "One opportunity identified is the need for more education on FTRs, particularly for smaller firms".

[12] It should be of concern to the Authority that Genesis thinks "The Authority's position can be summarised as: "it is unacceptable to structure offers to manage transmission constraints, except when the Authority determines it is acceptable, which will be made clear ex-post"".

[13] Electricity Authority, Open letter in response to a request for a review of the market for Financial Transmission Rights (FTRs), 10 November 2020. To avoid claims we have selectively quoted the open letter it is included in full as part of our submission.

increase prices to closer to value, reduce the LCE used to settle FTRs, and reduce the returns to speculation."

While, in and of themselves, FTRs are only one part of the mix of risk management tools that should be available, we agree with the Authority's FTR PIR conclusions that "Overall the introduction of the FTR market has been a success":

- "Evidence suggests that FTRs contribute to spot price risk management, increase the efficiency of other risk markets, have contributed to retail competition, and have been used in innovative ways that were not anticipated when FTRs were introduced."

- "Most FTR users consider them an effective tool to have in their risk management strategy. Of the seven gentailers and standalone retailers who use FTRs, five indicated that FTRs play a significant role in their risk management strategy."

- "… certain FTRs can function reasonably well as a substitute for an energy hedge or to offset a position on the futures market."

- "The LCE exactly corresponds to this difficult-to-hedge portion of LPR. Hence the LCE provides a natural source of funding for an LPR solution."

We also agree with the following Authority views articulated in the FTR consultation:

- **FTR provides a complementary/additional risk management tool to hedging:** "While energy hedging could have been used to manage most of the risk associated with losses (if there was a sufficient volume of energy hedges available), energy hedging would not have been an effective tool for managing LPR associated with reserves and transmission constraints. Inter-island LPR (between the North and South Islands) was a bigger problem than intra-island LPR (within either the North or the South Island)."

- "The Authority observes that market solutions to managing LPR are limited. … The FTR market may still be the best option to address unmitigable LPR."

- **Independent retailers are at a competitive disadvantage relative to vertically-integrated incumbents:** "The Commission considered that the regional market share differences between the major generator retailers was a strong indicator that the lack of suitable LPR management tools at the time was an impediment to more robust retail competition. If it was difficult for the large generator retailers to manage LPR, the Commission considered it was likely to be even more difficult for small prospective new entrant retailers."

- **Why isn't competition as strong as it should or could be?** "An alternative explanation could be that retail and generation competition would be less competitive without the presence of FTRs, and that the management of LPR through FTRs allows for a lower risk solution to the challenges of competition in a nodal price wholesale market."

It is unclear why the Authority appears to be changing its views from the post-implementation review and open letter

It appears from the "initial observations" the Authority has espoused in the FTR consultation paper that its views on the FTR market and so called "speculators" have changed since its 2020 post-implementation review and 2021 open letter.

The consultation paper's statement that "the link between FTRs and the intended improvement in retail and generation competition appears to be limited …" indicates the Authority is questioning whether its previous finding that "Evidence suggests that FTRs … have contributed to retail competition" was correct, but the paper doesn't make it clear why.

We are not sure how to reconcile the various views that "FTRs … have contributed to retail competition", "it is difficult to determine the influence that FTRs have on retail competition" and "the intended improvement in retail and generation competition appears to be limited".

The only information the Authority has released that appears to indicate why its views may have changed are the four synchronised letters from Genesis and Meridian in 2020, which the Authority's open letter appropriately rejected. The Authority stated that "during consultation some submitters raised other broader concerns about the current operation of other aspects of the FTR market"[14] but no submissions raised "broader concerns" of this nature. The "some submitters" would appear to be exclusively Genesis and Meridian and their letters (non-transparently) submitted outside of, but in parallel with, the FTR consultation process.

We are left in the position of largely agreeing with the Authority's earlier conclusions but being unclear about the reasons for the apparent changes reflected in the "initial observations". This has made it difficult to fully engage with the Authority's concerns and consultation paper. Our response to the principal matters raised by Genesis and Meridian, and the questions raised in the FTR consultation, is to support the Authority's previous conclusions and findings e.g.:

FTR consultation "initial observations"	**The Authority's earlier positions**
"Since its inception, concerns raised by market participants and observations by the Authority suggest the FTR market may not be addressing the problems it was created to solve."	15 Apr 2019 FINANCIAL TRANSMISSION RIGHTS – SUCCESSFUL PRODUCT FOR MANAGING RISK In June 2013, the Authority started the Financial Transmission Rights (FTR) market. The successful development of this financial risk management tool is helping the wholesale market mature. [15] "Overall the introduction of the FTR market has been a success. Evidence suggests that FTRs contribute to spot price risk management, increase the efficiency of other risk markets, have contributed to retail competition, and have been used in innovative ways that were not anticipated when FTRs were introduced."[16]
"many parties (particularly direct connect consumers and independent retailers) who are subject to LPR are not using the FTR market to manage LPR and are choosing to	"There appears to be a limited market for FTRs, with less than half of those interviewed buying or trading them. This may be more due to

[14] Electricity Authority, Update on consultation on changes to the Financial Transmission Rights (FTR) rental calculation, 26 January 2021.
[15] https://www.ea.govt.nz/about-us/media-and-publications/market-commentary/market-insights/financial-transmission-rights-successful-product-for-managing-risk/
[16] https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/

FTR consultation "initial observations"	The Authority's earlier positions
manage LPR in other ways, despite other market solutions for managing LPR being limited"	complexity, lack of education and other barriers to entry … rather than a lack of usefulness."[17]
"the link between FTRs and the intended improvement in retail and generation competition appears to be limited …" "Observation 2: Retail competition has increased over time, however it is difficult to determine the influence that FTRs have on retail competition.:	"Most FTR users consider them an effective tool to have in their risk management strategy. Of the seven gentailers and standalone retailers who use FTRs, five indicated that FTRs play a significant role in their risk management strategy."[18] "The successful development of this financial risk management tool is helping the wholesale market mature".[19]
Observation 3: There has been no apparent impact on generator competition due to FTRs. … One of the expected benefits from the introduction of FTRs was increased generator competition due to generators locating in regions subject to LPR.	"It is too early to tell whether FTRs will be a significant factor in generation location decisions. The relatively small amount of recent generation investment was likely committed before the start of the FTR market and has been driven mainly by proximity to renewable fuel sources."[20]
"that [sic] Authority have observed aggregate FTR funding to have increased over time since the FTR market started in 2013. This suggests a misalignment with the efficiency limb of the Authority's statutory objective. … Auction revenue has increased (due to auctioning additional FTRs) and there has also been an increase in the LCE allocation for FTR rentals due to contributions from additional network sections."	"The Authority does not believe that the evidence presented in these letters—that Haast Energy Trading has been winning a significant proportion of auctions—is reason for concern. Further, the evidence does not show Haast "cornering" the market for FTRs as stated by Meridian. "To the extent that Haast's participation (and that of other speculators) has the effect of increasing the price of FTRs to closer to their value (and Figure 2 suggests this is happening), its actions reduce the amount of reallocated LCE. This means less capital "syphoned off" and less profit for speculators. If there were no speculation in the FTR market—or speculation was discouraged—more LCE would be "syphoned off" and the beneficiaries of this would be physical players such as Meridian and Genesis."[21]
Observation 5: Some parties may be consistently profiting from FTRs without a clear benefit to consumers.	"As with other electricity derivatives such as ASX exchange traded products, there is both the hedging value of the risk management products themselves and the value of the associated

[17] https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/
[18] https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/
[19] https://www.ea.govt.nz/about-us/media-and-publications/market-commentary/market-insights/financial-transmission-rights-successful-product-for-managing-risk/
[20] https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/
[21] Electricity Authority, Open letter in response to a request for a review of the market for Financial Transmission Rights (FTRs), 10 November 2020. To avoid claims we have selectively quoted the open letter it is included in full as part of our submission.

FTR consultation “initial observations”	The Authority’s earlier positions
	forward price curve. For FTRs, speculators can enhance the robustness of the forward price by moving the price paid for FTRs closer to value. Since most of the speculators both buy and sell FTRs, they will also help to increase liquidity.”[22] “Another measure of success is the participants have broadened from generators, large industrial users and retailers, to increasingly also proprietary traders who use this product to be more active and support liquidity in the ASX futures and options market.”[23]
Observation 7: Many parties (particularly direct connect consumers and independent retailers) who are subject to LPR are not using the FTR market. Observation 8: FTRs tend to trade somewhat below ‘fair value.’ … The Authority has observed that FTRs are persistently profitable, meaning the FTR settlement often exceeds FTR acquisition costs. This suggests the market may not be reaching equilibrium, with no clear reason why.	“At this time we remain of the view that the best way for physical parties to increase their share of the FTR market, so as to better manage their locational risk, is to increase participation and bid prices in FTR auctions. This will increase prices to closer to value, reduce the LCE used to settle FTRs, and reduce the returns to speculation.”[24]
non-physical financial parties appear to be profiting from the FTR market and the link to consumer benefit is unclear.	**Speculators likely to increase FTR liquidity** 10.40 Certain FTR products sometimes trade in auctions at prices far higher than they eventually settle at. 10.41 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. 10.42 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. [25]
The Authority may need to reconsider the balance between efficiency benefits of the FTR market with the transfer of LCE to non-participants, particularly in light of the Authority’s recent work on the efficiency benefits identified in revisiting the allocation of LCE.	**Allocation of residual LCE** 11.1 The TPM proposals include an option to allocate the LCE (including residual LCE[23]) generated by each transmission investment to customers in proportion to the transmission charges they pay in respect of that investment.[24] 11.2 The FTR market has the effect of extracting much of the hedging property from this LCE stream. In fact, because auction revenue is used to support FTR settlements, a greater quantity of FTRs is allocated than could be supported by the LCE alone. This extracts even more hedging property leaving the residual LCE negatively correlated with nodal prices, ie, a sort of anti-hedge. 11.3 Nevertheless, averaged over time these payments should still support the efficiency intentions of this TPM option.[25] [26]

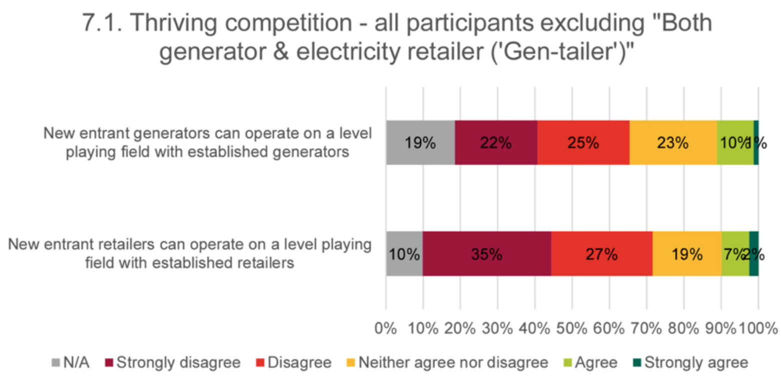
[22] Electricity Authority, Open letter in response to a request for a review of the market for Financial Transmission Rights (FTRs), 10 November 2020. To avoid claims we have selectively quoted the open letter it is included in full as part of our submission.
[23] https://www.ea.govt.nz/about-us/media-and-publications/market-commentary/market-insights/financial-transmission-rights-successful-product-for-managing-risk/
[24] Electricity Authority, Open letter in response to a request for a review of the market for Financial Transmission Rights (FTRs), 10 November 2020. To avoid claims we have selectively quoted the open letter it is included in full as part of our submission.
[25] https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/
[26] https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/post-implementation-review-of-the-ftr-market/

The Authority's FTR problem definition should take into account market participant perceptions about competition and the extent to which there is a level playing field

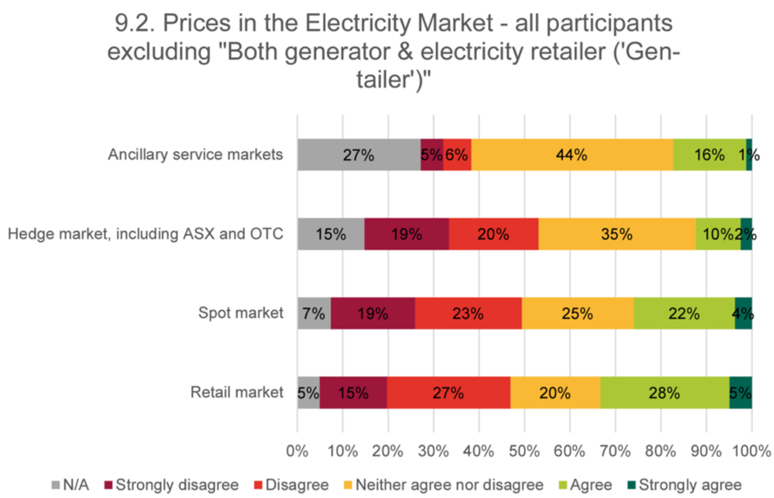
The results of the Authority's UMR survey and the MDAG work on the transition of the wholesale electricity market to 100% renewables are both directly relevant to the Authority's hedge and FTR market projects. The UMR survey finding, for example, included that:

- "19% [of market participants] agreed new entrant retailers can operate on a level playing field with established retailers." This consists of only 9% of market participants if gentailers, are excluded, and 0% of independent retailers.[27]

- "18% agreed new entrant generators can operate on a level playing field with established generators." This consists of only 11% of market participants if gentailers are excluded.



- "21% agreed hedge market, including ASX and OTC reflect the outcomes expected in a workably competitive market."[28] This consists of only 12% of market participants if gentailers are excluded, and only 8% of independent retailers



[27] Electricity Authority response to Official Information Act request, untitled, 15 March 2022.

[28] These results are likely to be heavily skewered (look for favourable) due to vertically-integrated gentailers making up 19% of the survey participants. We have requested the Authority provide the results separating out the impact of the gentailers on the results.

Where to from here?

We consider that the initial 11 "observations" and related questions raised in the FTR consultation are jaundiced and don't provide a neutral or sound basis for reviewing the FTR market in a way that would best promote the long-term interests of consumers.

For example, the Authority asks about whether the FTR market has features "that appear unintended or to have no clear consumer benefit" and that "negatively impact consumers" but doesn't ask any questions about the positive features of the FTR market. Likewise, the Authority asks "What benefit does speculation provide to the FTR market, and what link does this provide to consumers" but none of the discussion in the FTR consultation paper details the benefits the Authority previously articulated from financial traders' (and speculator) involvement in the market. Instead the Authority focussed on purported profits from speculation.

As part of next steps, the independents consider that the FTR market review should be re-oriented with a strong focus on development and evolution of risk management tools in the electricity market. The report by Dr Stephen Batstone for MDAG: "MDAG – Price Discovery with a 100% Renewables Wholesale Market Wholesale risk management practice trends in the NZ electricity market, and prospects for a high renewables future", October 2021, highlights many of the types of issues the Authority should be directing itself toward.

In particular, we consider that the Authority should address the following issues:

- **Adequacy of existing risk management tools:** The extent to which wholesale buyers can adequately cover their supply exposure;

- How liquidity in hedge and financial markets could be improved, including the role of financial traders/intermediaries;

- The implications of the expected increase in volatility and range of price outcomes from transitioning to greater reliance on renewable electricity;

- **The role of FTRs and how they fit with other risk management tools:** To what extent are FTRs achieving their initial purpose, and "[a]re there additional purposes and/or sources of value to the market that FTRs are, or should be, fulfilling or delivering?;[29]

- "What other mechanisms … can provide alternative ways to achieve some of these purposes? If such mechanisms exist, can they work alongside each other or as variations to current mechanisms to optimise value to load and other market participants?";

- **The extent to which there continues to be issues with use of inappropriate risk management tools** such as generation offers to manage transmission constraint risk and, as flagged by Sapere, whether issues with adequacy of risk management tools creates incentives to "move towards the vertical integration end of the spectrum";[30]

- **Divergence of market views about price:** Why there are suggestions (e.g. Sapere) of a "standoff between sellers of hedge products and buyers of hedge products" where "Buyers complain that even if products are available the prices are "too high"" and "Sellers tend to argue that buyers

[29] Drawing on London Economics, Review of PJM's Auction Revenue Rights and Financial Transmission Rights, 16 December 2020.
[30] Sapere, Implications for contract markets of transition toward 100% renewable market, 29 November 2021.

aren't prepared to pay the true value of covering price risk"[31] but this is flipped on its head with FTRs where the sellers of hedges complain FTR prices are too high and it appears they aren't prepared to pay the true value of covering price risk. Dr Batstone, on behalf of MDAG, raises the reasonable question "whether the underlying reasons for any gap points to wider issues with the way risk is evaluated and priced by market participants";[32]

- **Potential for evolution and reform of risk management tools:** What reforms would best 'future proof' the electricity sector and improve access to risk management tools. This may span the full spectrum of risk management tools, including hedge market, ASX CFDs, and FTRs.

  The work undertaken by Dr Batstone for MDAG on 100RE, for example, raises questions about the potential development of new profile or flexibility related products (caps, peak, superpeak, dry year products). Dr Batstone noted "Some gentailers believed that caps (for example) were likely to play a bigger role in the market as volatility grows with the transition to higher renewables". Dr Batstone raised the question: "Should the OTC market continue to be the primary channel for development and liquidity of shape-based products, or is there a case for amending existing product specifications on the ASX (e.g., move from peak to superpeak) and/or introducing new products (e.g., caps), potentially with market making obligations".[33]

Concluding remarks

The independents agree with the Electricity Price Review that: "An efficient contract market is particularly important for stand-alone retailers and generators, which are a key source of innovation and competitive pressure. Without an efficient contract market, innovators wanting to generate or retail electricity have to enter both of these markets at once".

To the extent the Authority has concerns "the link between FTRs and the intended improvement in retail and generation competition appears to be limited", or is difficult to ascertain, this highlights the need for additional, complementary reforms aimed at promoting competition. While FTRs are vital for promotion of competition they are not a 'silver bullet' for addressing the fundamental, structural problems in electricity retailing and generation. Nor should FTRs be blamed for competition not developing as well as should have been expected.

The Authority's priority should be promotion of competition and removal of barriers to competition; in particular, ensuring risk management tools are available that allow competition to occur between independent and vertically-integrated incumbent suppliers on a level playing-field. A consistent and principal focus of the independents has been on the need for better risk management tools that can address price squeeze and discriminatory behaviour issues. The issues raised in the consultation about the FTR market are inconsequential in the context of the current barriers to retail competition.

On the back of several years of ongoing, unprecedented high spot markets, the electricity retail market is struggling to operate in a competitive manner, with worrying signs in relation to market concentration statistics, independent electricity retailers withdrawing or reducing their competitive market engagement and potential new entrants delaying or declining to enter the market.

[31] Sapere, Implications for contract markets of transition toward 100% renewable market, 29 November 2021.
[32] Dr Stephen Batstone, MDAG – Price Discovery with a 100% Renewables Wholesale Market Wholesale risk management practice trends in the NZ electricity market, and prospects for a high-renewables future, October 2021.
[33] Dr Stephen Batstone, MDAG – Price Discovery with a 100% Renewables Wholesale Market Wholesale risk management practice trends in the NZ electricity market, and prospects for a high-renewables future, October 2021.

On top of this, MDAG have detailed how the transition to more renewable generation could increase generator market power and heighten the importance of risk management tools in the wholesale electricity market.

Yours sincerely,

Emma-Kate Greer GM Corporate Affairs and Regulatory Emma-Kate.Greer@2degrees.nz	Luke Blincoe Chief Executive luke.blincoe@electrickiwi.co.nz ELECTRIC KIWI
Sunil Unka Interim Chief Executive sunil.unka@flickelectric.co.nz FLICK	Sharnie Warren Chief Executive sharnie.warren@pulseenergy.co.nz pulse energy