Mercury

Via email: WholesaleConsultation@ea.govt.nz

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Financial Transmission Rights (FTR) market observations

Mercury welcomes the opportunity to provide feedback on Electricity Authority's (**Authority's**) paper, *Financial Transmission Rights market observations*: *Ensuring arrangements are fit-for-purpose,* 24 May 2022 (**Issues Paper**).

The Authority is seeking views on the FTR market and loss and constraint excess (**LCE**) allocation policy settings with a particular focus on the effectiveness of the FTR in managing locational price risk (**LPR**) for market participants. In particular, the Authority raises concerns that FTRs are not effective at addressing the problems they were created to solve, and consequently are not aligned with the Authority's statutory objective.

As an active participant in the FTR market, Mercury submits that the FTR market is a very valuable tool for managing LPR, both directly and indirectly. It allows electricity retailers and others to manage their LPR by directly purchasing FTRs. Electricity retailers also benefit indirectly from FTRs because FTRs are used by Mercury, and others, to manage the LPR inherent in national hedge products offered to retailers. In other words, it allows Mercury and others to offer electricity hedge products nationally to electricity retailers, because they are backed by a portfolio that includes FTRs.

Mercury submits that the Authority should consider both the direct and indirect benefits of FTRs to manage LPR. Any analysis of the effectiveness of FTRs that omits either of the direct or indirect benefits of FTRs will significantly underestimate the overall value of FTRs. Furthermore, any attempt to enhance the performance of the FTR market by amending policy settings which does not consider the potential impact of any amendment on both of the direct and indirect roles played by FTRs raises the risk of unintended, detrimental outcomes.

Mercury's response to the Authority's consultation questions is provided in the attached annex. This response takes into consideration both roles played by FTRs as highlighted above.

Mercury looks forward to engaging further with the Authority on its review on the role and performance of FTRs.

Yours sincerely

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Annex: Mercury response to the Electricity Authority's observations and consultation questions

Authority observation 1: Changes in the make-up of renewable generation will see LPR continue to change over the next 10 years.	
Authority question	**Mercury response**
1. What is your view on how LPR might evolve over the next decade?	Mercury considers that the significance and scale of the changes to the electricity market as a result of the electrification of the economy suggests that it is prudent to assume, when considering policy, that the LPR will evolve significantly. Mercury's view is that the LPR will evolve with the emergence of new sites for renewable electricity generation across geographic locations as well as the reduction in thermal electricity generation. Furthermore, LPR will evolve with changes in the geographic distribution of loads as a result of the move away from fossil fuels and electrification of the economy. There may also be one off events, such a possible closure of Tiwai Point, that would impact LPR. Mercury considers that this means that the Authority would give best effect to its statutory objectives by allowing the market to develop a range of solutions efficiently for managing LPR, including how FTRs might be incorporated in these solutions.
2. Do you see LPR as a genuine risk to your business? Why/why not?	LPR will continue to be a risk to Mercury's business because load and generation are not collocated. As noted above, it is prudent to assume when considering policy that this risk will evolve significantly as a result of the significant changes in load and generation, size and distribution due to the electrification of the economy.

Authority observation 2: Retail competition has increased over time, however it is difficult to determine the influence that FTRs have on retail competition.	
Authority question	**Mercury response**
3. What influence has the availability of FTRs had on your decision to compete for consumers?	FTRs have enabled Mercury to more effectively hedge the locational price exposure in our portfolio and enhance our ability to compete in retail electricity markets across all distribution networks in New Zealand. For instance, as an integrated generator-retailer with North Island generation assets, FTRs enable Mercury to hedge South Island risk thereby enhancing Mercury's ability to compete for customers in the South Island.
4. What benefits do you see the FTR market providing in terms of consumer outcomes? Why/why not?	As already noted, the FTR market allows electricity retailers and others to manage their LPR by directly purchasing FTRs. Electricity retailers also benefit indirectly from FTRs because FTRs are used by Mercury and others to manage the LPR inherent in national hedge products offered to retailers. That is, it allows Mercury and others to offer electricity hedge products nationally to electricity retailers, because they are backed by a portfolio that includes FTRs. Additionally, due to multiple nodes being traded in the Futures market, the FTR market enables greater Futures liquidity as parties can hedge exposures in one market with positions in another. Increased hedge market liquidity enables wider competition which ultimately benefits consumers.

Authority observation 3: There has been no apparent impact on generator competition due to FTRs.	
Authority question	**Mercury response**
5. What influence has the availability of FTRs had on your generation investment decisions?	The availability of FTRs and the direct and indirect roles they play as discussed above has a positive influence on generation investment decisions in general. However, LPR and the availability of products to hedge this risk is only one of many considerations when assessing the merits of a generation development project.
6. Has the FTR market	See answer to question 5.

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allowed your business to build new generation plant in new geographic areas? Why/why not?	

Authority observation 4: FTRs currently use an average of $5.29 million per month from LCE (~47% of total LCE) to settle.	
Authority question	**Mercury response**
7. Does the current use of LCE to support the settlement of the FTR market deliver the best outcomes for consumers? Why/why not?	Mercury considers that the use of the LCE to support the settlement of the FTR market delivers the best outcomes for consumers. The importance of preserving the integrity of the FTR product as a hedge requires the confidence of parties that settlements can be met. As already noted, FTRs play a direct and indirect role in the wider NZ electricity derivative portfolio. Any degradation in the hedge attributes of FTRs is likely to impact the liquidity in other hedge products that provide short and medium term price discovery, which underpins consumer pricing across all channels.

Authority observation 5: Some parties may be consistently profiting from FTRs without a clear benefit to consumers.	
Authority question	**Mercury response**
8. Why do you think some FTR participants are profiting from FTRs more than others?	Mercury considers that the transparency of the FTR market enables all parties to make informed decisions about how best to manage their exposure to LPR. Some parties may have been more profitable than others over a period for a number of reasons including: maintaining a superior hedge policy; differing views about forward prices; differing appetite for trading risk; and market outcomes across a period that happened to favour one party over another. Additionally, as noted above, any analysis of the effectiveness of FTRs that omits either of the direct or indirect benefits of FTRs will significantly underestimate the overall value of FTRs for all parties.

Authority observation 6: The LPR due to losses is highly correlated with energy prices while LPR due to constraints is not.	
Authority Question	**Mercury response**
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?	Yes, ensuring the integrity of FTR settlement is crucial to the viability of FTRs as a hedge product for retailers. See our response to question 7.

Authority observation 7: Many parties (particularly direct connect consumers and independent retailers) who are subject to LPR are not using the FTR market.	
Authority question	**Mercury response**
10. Why do you think organisations that are exposed to LPR are not participating in the FTR market (directly or indirectly)?	As already discussed above, organisations that are exposed to LPR can and do benefit from the FTR market directly and indirectly. That is, it allows electricity retailers and others to manage their LPR by directly purchasing FTRs. Electricity retailers also benefit indirectly from FTRs because FTRs are used by Mercury, and others, to manage the LPR inherent in national hedge products offered to retailers. In other words, it allows Mercury and others to offer electricity hedge products

	nationally to electricity retailers, because they are backed by a portfolio that includes FTRs.
11. What do you think can be done to maximise the efficient use of LCE for the benefit of consumers?	Mercury submits that the efficient use of LCE for the benefit of consumers and its effectiveness as a hedge would be enhanced by the Authority: • signalling its continued commitment to using the LCE to underwrite FTRs; and • considering to increase the value of the allocation of the LCE to FTRs.
12. Do you consider LPR to be an impediment to effective retail and generation competition? Why/why not?	Mercury considers that the LPR is a market risk and a general impediment to both retail and generation competition.
13. How does the FTR market allow you to manage LPR? What non-FTR market tools do you use to manage LPR?	As already noted, FTRs have enabled Mercury to more effectively hedge the locational price exposure in Mercury's portfolio and enhance Mercury's ability to compete in retail electricity markets across all distribution networks in New Zealand.
14. Are changes required to the FTR market for the long-term benefit of consumers? Why/why not?	Mercury considers that an increase in the number of FTR hubs will benefit consumers in the long term. As already noted, Mercury considers that the significance and scale of changes to the electricity market due the electrification of the economy suggests that it is prudent to assume, when considering policy, that LPR will also evolve significantly. Increasing the number of FTR hubs would provide the industry with some flexibility to facilitate the process of adjusting with this evolution in the LPR.

Authority observation 8: FTRs tend to trade somewhat below 'fair value.'	
Authority question	**Mercury response**
15. Do you agree with the view that FTRs are currently traded below 'fair value'? If yes, why do they trade below fair value?	Mercury believes that at the time of auction FTRs are traded at fair value. There is a relationship between location price differences and the underlying electricity price. With higher underlying price comes higher locational price differences. Recent market trends suggest that Spot and Futures price may be trading higher than the expected price implicit in past FTR auctions. In this environment, it is expected that FTR positions held would be 'in-the-money'. Additionally, given the relationship between the products, participants reference the Futures price as a key factor when determining their bids for FTR auctions. The following graphs compare the FTR auction clearing price with the Futures price at the time of auction for BEN-ISL and WKM-OTA FTR options at BEN and OTA hubs, in Jan and Feb 2022.

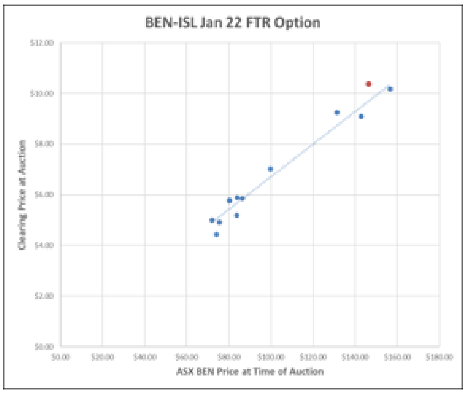

Figure 1: Bids for the Jan 22 BEN-ISL FTR Option against the ASX BEN price at the time of auction

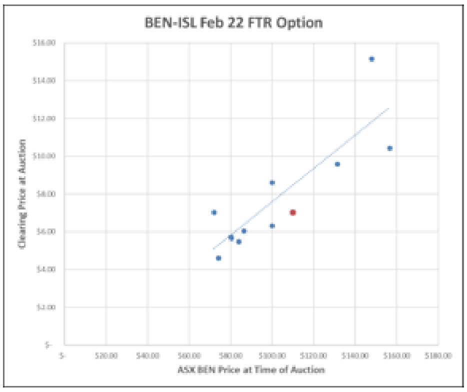

Figure 2: Bids for the Feb 22 BEN-ISL FTR Option against the ASX BEN price at the time of auction

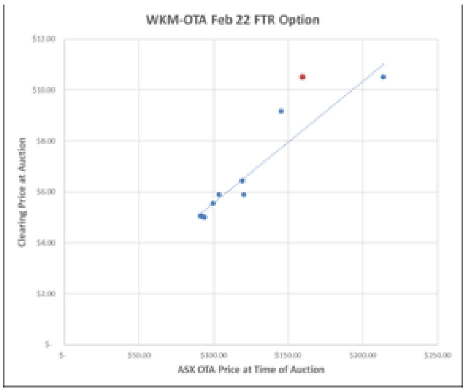

Figure 3: Bids for the Feb 22 WKM-OTA FTR Option against the ASX OTA price at the time of auction

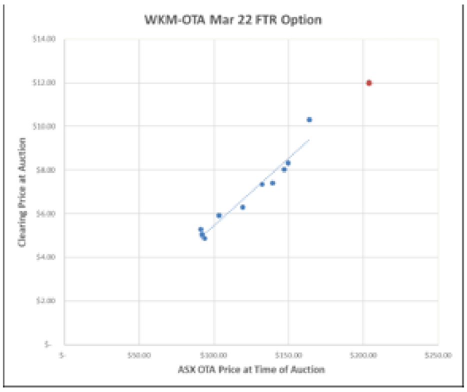

Figure 4: Bids for the Mar 22 WKM-OTA FTR Option against the ASX OTA price at the time of auction

The blue dots in these graphs are the clearing prices for the auctions plotted against the Futures contract price on the day of the auction. As the trendline suggests, these seem to follow a linear relationship. The larger red dot is the FTR final settlement price plotted against the average monthly spot price for the FTR month.

Mercury notes, in particular, that the settlement price in figure 2 is below several the auction clearing prices. This suggests that the participants that purchased those FTRs would have incurred a loss.

16. Should FTRs be traded at/closer to 'fair value?'	Referring to our answer to Q15, it is our view that FTRs are trading at the fair value at the time that the bids are submitted.

Authority observation 9: Some features of the FTR market appear to be unintended and have no direct link to consumer benefit.	
Authority question	**Mercury response**
17. Are there other features of the FTR market that appear unintended or to have no clear consumer benefit?	No.
18. Does the feature of the FTR market identified by the Authority negatively impact consumers? How?	No.

Authority observation 10: The Financial Markets Authority does not regulate trading conduct in the FTR market.	
Authority question	**Mercury response**
19. Do you think there is a requirement for enhanced oversight of the FTR market?	No.

Authority observation 11: Revenue adequacy settings of the FTR market contribute to the profitability of FTRs.	
Authority question	**Mercury response**
20. What are your views on speculators benefiting from the design of the FTR market?	Mercury considers that more participation in the FTR market is likely to result in better price discovery, which in turn is likely to benefit consumers. Mercury's view is also that the speculators in the FTR market are likely to also participate in the Futures market. As stated above this relationship enables more liquidity in the Futures market.
21. What benefit does speculation provide to the FTR market, and what link does this provide to consumer benefit?	See our response to question 20.