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## Financial Transmission Right market observations - Issues paper

Dear James,

Thank you for giving us the opportunity to provide feedback on the points raised by the Authority in the Financial Transmission Rights market observations issues paper. In the letter below I outline my observations of the FTR market and provide some feedback to the Authority on the issues raised in the paper.

### Product Use

FTRs were introduced to help mitigate locational price risk, but the product has many more uses. FTRs are extremely versatile and aid retail and generation competition in other ways. FTRs can be, and currently are, used for more than just a locational price risk hedge. Energy market participants are able to hedge the following risks using FTRs:

- **Energy price risk**  
As you have shown in the issues paper, there are a number of FTR contracts that correlate very highly with energy prices, giving participants an alternative product to hedge energy price risk.
- **Hydrology (generation/fuel) risk**  
Hydrology, or more generally electricity generation, affects the flow of electricity on the grid and in turn affects the payouts of FTR contracts. FTR pairs payout differently depending on the hydrology scenario and on the electricity generation from different generation assets. Electricity generators are able to hedge the hydrology/fuel risk using FTRs.
- **Peak price (capacity) risk**  
FTRs settle per trading period giving participants the ability to hedge peak pricing or generation capacity risk.

All of these attributes mean the FTR market creates an overall more effective risk management environment. More effective risk management means greater retail and generation competition and lower long term cost to the consumer.

### Retail Competition

Electricity retail participants have benefited directly and indirectly from the FTR market via increased competitiveness and a lower cost to serve. Participation by independent retailers in the FTR market shows how the FTR market benefits retail competition directly. Independent retailers can and are using FTRs to hedge locational price, energy price and peak price risks, reducing their risk, thus reducing their cost to serve.

The indirect benefits are harder to see, but they do exist. An independent retailer that is not an FTR participant can get an energy hedge from another energy market participant, one that is an FTR participant and one that uses the FTR market, to hedge the transferred risk. For example, say an independent retailer secured customer load in Wellington. They then become short energy and are exposed to energy price risk at HAY. Since they're not an FTR participant the way they would hedge this risk is via an energy hedge from another participant (e.g. a Gentaileer). The Gentaileer sells a hedge to the independent retailer at HAY, transferring the HAY energy price risk to the Gentaileer. The Gentaileer, who is an FTR participant, then

purchases FTRs to hedge the risk (e.g. if the Gentailer had generation in WKM they would purchase a WKM/HAY obligation (this has the effect of transferring energy length from WKM to HAY, offsetting the HAY price risk)). So even though a retailer is not an FTR participant, they still benefit from the FTR market because it provides other participants a way to hedge risk and provide competitive cover for participants looking to transfer risk.

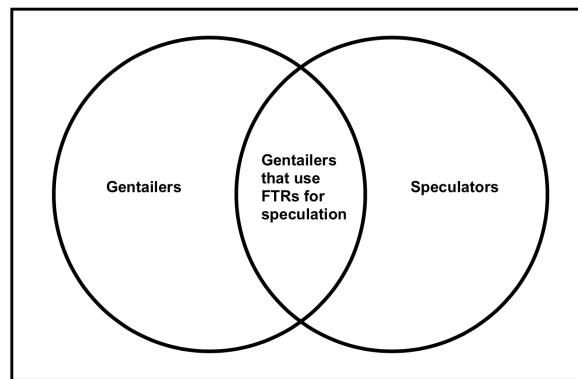
## Speculation

The questions posed by the Authority to participants regarding speculation and speculator's access to the FTR market are redundant. The Gentailers will argue that speculator access to the FTR market should be denied. This is because the Gentailers are incentivised to reduce competition. The non-physical financial entities will argue that speculators should continue to access the FTR market. This is because the non-physical financials are incentivised to continue participating in the FTR market. It's hard to see the Authority receiving unbiased opinions on this.

The suggestions and questions raised in the issues paper come across as seeming that the Authority is under the following assumptions:

- Gentailers do not speculate in the FTR market.
- By removing the non-physical financial participants, speculation in the FTR market will cease.

Both of these assumptions are incorrect. Below is a very simple representation of the FTR market:



Gentailers speculate in the FTR market. Clear and simple. One Gentailer was even conspicuous in their speculative activity by having multiple FTR accounts to separate the hedge trades from the speculative trades. The other Gentailers are more inconspicuous, but you can generally make the distinction between hedge trades and speculative trades when you look at the FTR register.

Since the Gentailers speculate, removing the non-physical financial participants from the market will not put an end to speculation. Removing the non-physical financials would only reduce competition, pushing FTR auction prices further away from their 'fair value', driving the use of LCE in FTR settlements up and increasing the cost to the end consumer, all the while increasing revenue generation and earnings for the Gentailers.

We are a non-physical financial entity so our view is that speculators should retain access to the FTR market. Markets benefit from speculators in two main ways; they add liquidity and they help in price discovery. Take for example the OTA/WKM obligation. Physical electricity usually only flows from WKM to OTA, so a participant would usually only purchase a OTA/WKM obligation if they thought the WKM/OTA contract was priced too high. Since the WKM/OTA payout is highly correlated to the OTA energy price, you could say that they thought the WKM/OTA was priced too high relative to the OTA ASX futures contract. This can be viewed as a speculative trade. If WKM/OTA is priced high compared to the OTA ASX futures then the trade is to purchase the OTA/WKM obligation, sell the OTA ASX futures contract, and receive the difference as an 'arbitrage' profit. The effect from this trade on the market is two-fold:

1. Bidding for and purchasing the OTA/WKM obligation drives the price of the WKM/OTA contract down and closer to the OTA futures price, resulting in more efficient pricing across the different markets.

2. This trade adds liquidity to both the ASX futures market and FTR market. The purchase of the OTA/WKM obligation acts the same way as the sale of a WKM/OTA contract, they both add available capacity to WKM/OTA. The WKM/OTA price was higher in the first place due to excess demand, the purchase of the OTA/WKM obligation adds liquidity to satisfy the excess demand for WKM/OTA contracts.

This example shows that speculative trading in the FTR market aids in efficient pricing and adds liquidity. As a note for consideration, there has been ~600 GWh<sup>1</sup> of OTA/WKM obligations traded since January 2020. I chose to use OTA/WKM as an example because, since January 2020 the WKM/OTA FTR has had the largest trading volume out of all FTR pairs, accounting for ~11% of total traded MW. This shows that speculative activity added liquidity to the top traded FTR contract used by participants for hedging.

### Optimal outcome for consumer

To arrive at the optimal solution for consumers two things need to happen:

1. The amount of LCE used in the settlement of FTRs should be zero (as measured over a timeframe).
2. A highly active and competitive FTR market.

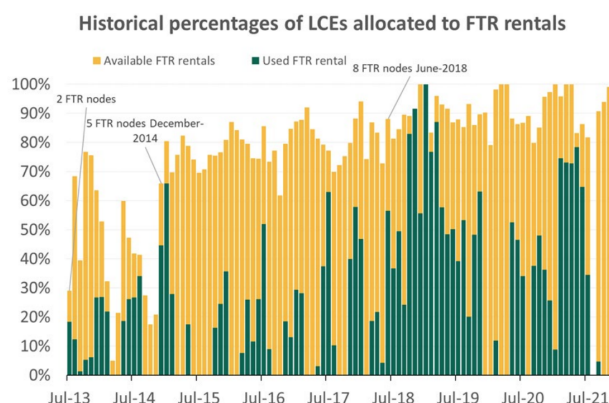
This cannot be achieved if the Authority sets the LCE used for FTR settlements to zero. If the LCE used for FTR settlements was set to zero, participation and activity in the FTR market would drop substantially. The incentive to participate disappears. The value of LCE would be transferred directly to the consumer, but we would lose an effective hedge market. Hedging then becomes expensive, competition drops, and cost to serve for independent retailers increases, all to the detriment of the consumer. The benefit to the consumer from receiving the LCE, instead of it being used for FTR settlements, would be outweighed by the increased costs associated with lower competition and higher hedging costs.

So how do we get to the point where the LCE used for FTR settlements is zero without setting it to zero? If the market is open and encouraged to grow, the market will naturally tend toward LCE used for FTR settlements being zero over the long run. When activity and participation increases as more participants enter and trading becomes more competitive, FTR auction prices will tend towards FTR settlement prices. As this happens, the level of LCE used for the settlement of FTRs will tend toward zero.

The best solution for the long term benefit of consumers is to have an efficient market creating an effective risk management environment, as it promotes competitiveness and lowers costs to the end users.

### Questions

1. The below chart (Figure 14 in the issues paper) shows the percentage of available and used FTR rental amounts for FTR settlement per month. Has any analysis been done on identifying the drivers of the level of used FTR rentals? If so, what is the cause of high/low levels of used FTR rentals?

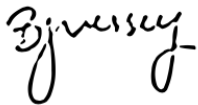


<sup>1</sup> Figures come from the FTR register post June 2022 variation auction.

2. The current FTR market is lacking an active secondary market. There is currently no platform to facilitate secondary market activity. Third parties are hesitant to build anything due to the perception that demand for the service is too low. A thriving secondary market for FTRs would add another layer of pricing efficiency and liquidity, making the market more effective. Has or would the Authority consider building a platform for secondary trading activity in the FTR market?
3. Participation in the FTR market remains low with knowledge/experience being a barrier to entry. Does the Authority plan to increase awareness and knowledge of the FTR market to reduce barriers to entry and increase participation levels?

Please let me know if you have any questions regarding this letter.

Yours faithfully,

A handwritten signature in black ink, appearing to read "B. Vessey". The signature is written in a cursive, flowing style with a long horizontal stroke at the end.

Brad Vessey  
Director  
Acropolis Energy Trading Ltd