

Hedge Market Enhancements

Enduring market making approach

Decision summary

25 August 2020

1 Decision

- 1.1 The Authority is minded to explore an enduring market making approach that builds on the success of the current arrangements while transitioning to an efficient scheme that improves market confidence and is service oriented. The approach:
- (a) transitions, over a period of years, to an incentivised market making arrangement where market making services are performed by commercial providers; and
 - (b) ensures market making services are provided in the interim period through a combination of mandated market makers and commercial providers.
- 1.2 The Authority is minded to explore this approach following several consultation rounds and stakeholder engagement, and after observing market performance during recent stressful events. This approach builds on the success of the current arrangements which have performed well over most of the past ten years and particularly through recent market stress events in 2020.

First step in the transition

- 1.3 The Authority's priority at all times is to provide for the long-term benefit of consumers by ensuring that market making services support a robust forward price curve and enable efficient risk management. The Authority considers that the main public good provided by market making arrangements, from which all sector participants benefit, is the forward price curve. In considering ways in which to enhance and build upon the successes of existing market making arrangements, the Authority is mindful of the need to maintain the integrity of the forward price curve.
- 1.4 The first step in the transition to the enduring arrangements will involve concurrent mandated and commercial providers of market making services.
- 1.5 The mandated parties will be the existing market makers: Contact, Genesis, Mercury, and Meridian. Under this scheme, the Authority will amend the Code to place an obligation on those parties to provide market making services. The Authority will decide the detailed design of these arrangements over the coming months, and will be guided by the recent success and resilience of the current arrangements. As is currently the case, the mandated parties would not be compensated by the Authority for the services they provide. Before amending the code, the Authority will undertake a cost-benefit analysis and consult stakeholders.
- 1.6 In addition to, and operating concurrently with the mandatory scheme, the Authority will seek to procure one or more commercial market makers who will provide services for payment. The Authority will explore several options for raising and allocating the funds

for a commercial scheme, including by way of its existing levy powers. The cost of this commercial scheme will be allocated to the beneficiaries of the additional market making, including the mandated market makers. The Authority will seek to align the services provided under the commercial scheme with those provided under the mandatory scheme. The Authority will consult with impacted parties on possible changes to levy rates to meet the costs of the commercial provider.

Interim steps in the transition

- 1.7 Over time, the Authority intends to transition away from mandated providers of market making services towards commercial providers of market making services. This could involve increasing the number of commercial providers and decreasing the number of mandated providers over several years. This could see an increase in the costs that are recovered from the beneficiaries of market making. However, there are many ways this transition could happen, and the Authority has not yet decided which transition method is in the best long-term interests of consumers.
- 1.8 The transition period will likely take several years, and it is also possible that the Authority decides it is appropriate physical participants provide market making services indefinitely.

Final step in the transition

- 1.9 The Authority considers that the final state of the enduring scheme will be a standalone incentivised market making scheme under which the Authority will procure market making services from the lowest cost commercial providers, and the cost of the scheme is recovered from the beneficiaries. The Authority is mindful of the need to ensure that at all times that market making services are provided and the integrity of the forward price curve is maintained, even under a standalone incentivised scheme. The Authority considers that a standalone incentivised market making scheme will be for long-term benefit of consumers, and is likely to be the most enduring approach to market making.

2 Next steps

- 2.1 The Authority will release a full decision paper later in the year, likely in November. The decision paper will set out the Authority's decision in more detail, including its current thinking on who the beneficiaries of market making are, and how the cost of a commercial scheme would be recovered. It will set out a roadmap for implementing the Authority's decision and also respond to stakeholder feedback. Authority staff will be available to discuss the decision paper with any interested parties.
- 2.2 The current mandatory backstop market making arrangements in the Code will expire in early November. The Authority will continue to closely monitor the exchange traded futures market and market making performance. The Authority will take decisive action if the long-term interests of consumers are put at risk.