14 April 2025

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# Expiry of urgent Code amendment regarding market making under high stress conditions

Genesis provides market making services to support the New Zealand electricity futures market and welcomes the opportunity to provide feedback on the Electricity Authority's consultation paper "*Expiry of Urgent Code amendment regarding market making under high stress conditions*" (**Paper**).

We have approached the Paper based from first principles:

1. Market making is foundational to the health and efficiency of futures markets. It supports liquidity, price discovery and market stability.

2. During periods of significant market stress:

   (a) These functions are critical.

   (b) The risks and costs of market making rise significantly, which can lead to market makers withdrawing partially or entirely from market making.

3. The consequences of market making withdrawal are material and far reaching. These include the impact on risk management and investment decisions, and integrity and confidence in the wholesale electricity market.

Futures, commodities and equities markets globally, recognise these principles and have implemented various mechanisms designed to provide relief to market makers during stressed market conditions. These include circuit breakers, fast market protocols and spread widening / obligation quoting allowances.[1]

The New Zealand market making regime is relatively new and has evolved over time to include provisions that allow market makers a limited number of exemptions from their market making obligations.[2] These were not, however, designed to deal with sustained periods of high market stress such as that experienced over the 2024 winter. Amongst other things, these arrangements did not cater for a scenario where

[1] See Schedule 1 for examples.
[2] Five trading days per rolling 20 trading days.

a market maker could still provide market making services albeit at wider spreads and / or different volumes.

The events of Winter 2024 were unprecedented leading to a sustained period of stress in the New Zealand electricity futures market. Given the potential risks from a significant disruption to market making, the Authority decided to intervene:

(1) By advising that, for a temporary period, it would exercise discretionary powers not to take enforcement action provided market makers continued to provide services within certain threshold.

(2) Introducing a temporary Code amendment to implement a wider bid-ask spread for periods of high market stress, which would be triggered when settlement prices equal or exceed $500/MWh.

We acknowledge that there have been criticisms from some market participants in relation to these interventions.

While not everyone agreed that there should have been an intervention or with the specific relief mechanism, Genesis considered that a relief mechanism was necessary given the circumstances faced by the market and the wider industry at the time. As a matter of principle, we support mechanisms that provide targeted and proportionate market making relief where this is necessary. This approach is consistent with practice in futures, commodities and equities markets globally, and recognises that, in extreme circumstances, it is preferable to have constrained market making services than a material reduction or none at all.

The Authority's preference is to let the market making relief provisions expire on 12 June 2025 and revert to the previous market making settings (**Option 1**). For the reasons set out below, we consider the Code amendment should be made permanent (**Option 2**) and amendments made if necessary, following the wider review of market making signalled by the Authority for later this year.

## The Authority's Preferred Option – letting the Urgent Code amendment expire

The Authority's preferred option means that the temporary increase in the bid-ask spread from 3% to 5% on contracts where settlement prices equal or exceed $500/MWh will cease.

The principal drivers for the Authority's preference are:

(1) concerns that permanent relief could negatively impact market liquidity;

(2) its belief that existing exemptions (five per rolling 20 trading days) are sufficient; and

(3) its expectation that other initiatives will reduce market stress going forward.

### *Flawed Liquidity Impact Assessment*

The Authority argues that the wider 5% spread under the amendment harms liquidity, citing analysis from August 2024. However, that analysis relates to a period of temporary discretionary relief where spreads were much wider (initially 15%, then 8%). It is questionable whether the negative impact of an 8-15% spread accurately predicts the impact of the more modest 5% spread (and which is only triggered when prices exceed $500/MWh). Further, the Authority acknowledges the amendment's trigger ($500/MWh) has not been met yet, meaning there is no direct empirical data on its actual market impact. We suggest that the significant decrease in trading volumes observed in August 2024 was likely caused by: (a) much larger spread increases (8-15% vs. 5%); (b) the Authority's discretionary intervention rather than a predictable rule-based mechanism and (c) market uncertainty during this period.

The Authority also points to the stable trading volumes (excluding the commercial market maker) during the high-priced week of August 2024 as evidence that the market can function without the urgent Code amendment. However, this period coincided with the Authority's temporary relaxation of enforcement and the subsequent urgent Code amendment coming into effect. It is difficult to isolate the true impact of market stress on trading behaviour without any form of relief mechanism in place. The claim of stable volumes also notably excludes the impact of the commercial market maker's absence.

The potential for a "cascading failure" of market makers withdrawing their services under severe and unmitigated stress remains a valid concern. As discussed above, it is preferable to have constrained market making and liquidity for a temporary period than very little or none at all.

### *Inadequacy of Existing Exemptions*

The events of Winter 2024 demonstrated that the exemption system (five exemptions per 20 trading days) may be insufficient during prolonged stress periods:

- Some market makers had exhausted or nearly exhausted their allowed exemptions.
- This situation required emergency intervention by the Authority.

While market makers may have since used exemptions more conservatively, this behavioural change: is based on a limited timeframe post-crisis and is more likely to have been driven by relatively benign market conditions to the period leading up to August 2024; may not persist in future stress scenarios (and a sufficiently severe future event could still rapidly deplete exemptions); and relies on assumptions about behavioural adaptation rather than structural safeguards.

Even if the Authority's view of the underlying driver of the more conservative use of exemptions is correct, the Authority assumes market makers will "manage their exemptions carefully" without providing safeguards for extreme scenarios that might exhaust even carefully managed exemptions.

We consider that reliance on behavioural change is less robust than a codified mechanism, especially as the Authority itself acknowledges the risk of exit if exemptions are exhausted during stress. Further, relying only exemptions for market making relief exposes the market to the risk of market makers withdrawing services if future periods of high stress are prolonged or more severe than anticipated. That risk cannot be ruled out, and Option 1 creates uncertainty about how future stress events will be handled, potentially requiring interventions like August 2024. We disagree with the Authority's qualitative assessment that Option 1 is neutral with respect to regulatory certainty. We consider Option 1 weak in this respect, and as we discuss below, predictability should be preferred to ad hoc intervention.

***Undue reliance on future initiatives***

The Authority considers that ongoing initiatives to strengthen security of supply will reduce the need for market maker relief. However, these initiatives are either just beginning or planned for the future and, while important, their effectiveness remains untested and uncertain. Further, while these aim to address the underlying causes of high prices, their success in preventing future market stress is not guaranteed and the electricity market remains vulnerable to unforeseen events (e.g., the Pohokura outage in 2018). Unpredictable events can still lead to rapid and significant price increases, regardless of broader security of supply improvements. Keeping the Code amendment offers a concrete, existing safeguard against severe disruption.

***Other matters – OTC derivatives***

The Authority refers in the paper to alternatives for risk management products, such as the OTC market. The OTC market was previously observed as operating as a substitution during the Pohokura interruption to the futures market, as well as providing an alternative for market participants who lost access to the ASX market when their clearing participant access was lost. However, as the Authority acknowledges, the OTC market is not a perfect substitute. Further, as OTC product pricing is informed by ASX electricity futures pricing and in some cases, backed by ASX electricity futures, market making disruptions would impact the OTC market and the availability of these products.

***Other matters – Downplaying financial losses***

While market maker losses could be seen in a portfolio context, the Authority previously acted specifically due to concerns that market-making losses relative to Code penalties could prompt withdrawal. To downplay this risk now seems inconsistent. Further sustained losses in a specific required activity can lead to exit pressures, regardless of overall corporate health.

### *Other matters – Modifying the urgent Code amendment provision (Option 3)*

Further alternatives to providing relief to market makers in high stress periods should be considered as part of the wider review of market making signalled for later this year. The non-enforcement intervention and urgent Code amendment were not widely consulted on and undertaken as a reaction to market conditions and assessments at the time. There are a range of relief mechanisms that are used in futures and other markets, each with their advantages and disadvantages. Examples of these are set out in Schedule 1. Given the importance of market making, these should be carefully considered as part of the wider market making review that the Authority has proposed.

## Our Preferred Option – keep the Code amendment

While the Authority prefers expiry, we submit that a compelling case exists that making the amendment permanent offers a more robust, predictable, and confidence-enhancing approach to managing the risks of market stress. For the reasons discussed below, we ask that the Code amendment is retained, and adapted if necessary, following the wider market making review.

### *Ensuring Market Stability and Confidence*

Past events (Pohokura 2018, Winter 2024) have shown the futures market's vulnerability to stress, which can lead to market maker withdrawal and prolonged disruption. A permanent, predictable relief mechanism provides confidence to market makers that their risk is managed in extreme conditions, making them less likely to withdraw services when they are needed most. The amendment acts as a crucial, predefined safety valve to prevent a systemic breakdown. This enhances confidence for all market participants relying on the futures market for risk management and price discovery. Market confidence and integrity is critical, and the Authority's criteria assessment acknowledges Option 2 supports market confidence better than Option 1.

### *Asymmetric Risk Profile Favors Prevention*

As discussed in the paper, the potential consequences of market maker withdrawal are severe and long-lasting. They include:

- cascading market maker exits;
- damage to participant and public confidence in futures markets;
- negative implications for the wider wholesale market;
- slow market maker re-entry process.

Compared to these risks, the modest cost of slightly wider spreads during limited high-price periods represents prudent risk management. This is an asymmetric risk profile where the cost of prevention is far lower than the cost of the potential negative outcome.

### *Targeted and Proportionate Relief*

The amendment is not a blanket relaxation. It only triggers at a high price threshold ($500/MWh), indicating significant stress, and offers only a modest widening of the spread (3% to 5%), while maintaining volume obligations. This is far less drastic than the 8-15% spreads seen during the ad-hoc relief period. It is a calibrated response and a balanced approach that ensures market makers can continue fulfilling their core functions when these are most needed.

### *Providing Regulatory Certainty*

The amendment provides a clear, objective, and transparent mechanism. This is preferable to the uncertainty and potential delays associated with relying on future discretionary interventions by the Authority, as occurred in August 2024. Predictability benefits all market participants.

Option 2:

- signals the Authority's commitment to market stability;
- creates a predictable, rules-based relief mechanism;
- avoids the need for discretionary interventions which can be controversial; and
- establishes clear expectations for all market participants.

The Authority's preference for Option 1 creates uncertainty about how future stress events will be handled, potentially requiring ad-hoc interventions like August 2024.

### *Addressing Increased Market Volatility*

The market faces inherent and potentially growing volatility (e.g., from renewables, fuel supply issues). Acknowledging this reality suggests that building in resilience through a mechanism like the amendment is prudent, rather than relying on settings established before the most recent severe stress events.

## Summary

Option 2 - maintaining the Code amendment - represents a minimal, proportionate response to market stress that supports continued market making when it matters most. It is a clear, predictable mechanism for maintaining market function during exceptional circumstances, rather than relying on reactive interventions or hoping that market discipline and behavioural change alone will suffice. There are other mechanisms for providing relief to market makers in periods of high market stress. Given the importance of market making, these alternatives should be considered as part of the Authority's proposed review of market making.

Please contact me if you have any questions or would like to discuss our submission further.

Yours sincerely

Warwick Williams
Senior Regulatory Counsel and Group Insurance Manager

## SCHEDULE 1

### Examples of Market Making Relief Mechanisms

| Mechanism | Description | Benefits | Disadvantages |
| --- | --- | --- | --- |
| 1. Fast Market (Nordpool) | This option involves suspending market maker obligations when the market moves beyond a certain point until prices stabilise or for a set period. | Provides immediate relief during extreme volatility.<br><br>Prevents cascading effects of rapid price movements.<br><br>Allows market time to stabilise.<br><br>Protects market makers from unforeseen risks. | May create temporary liquidity / price discovery gaps.<br><br>Defining trigger points may be challenging. |
| 2. Circuit Breakers<br><br>(SGX, CMC) | This option prevents the market from moving beyond certain points (e.g., 10%), with gradual resets to wider ranges (e.g., 20%) if breached. They can be market wide, product specific or dynamic. | Offers a structured approach to handling extreme movements.<br><br>Prevents extreme losses.<br><br>Allows for gradual market adjustment. | May be challenging determining appropriate calibration levels. |

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| | | Provides time for information dissemination and risk assessment.<br><br>Liquidity and price discovery still available | |
| 3. Daily Limit Move<br><br>(CME) | Prevents market move beyond a daily limit | Prevents extreme intraday price swings.<br><br>Provides a clear framework for price movements. | Hinders price discovery.<br><br>Can lead to increased uncertainty when limits are hit.<br><br>May cause market distortions.<br><br>Can result in liquidity issues when market locks limit up/down. |
| 4. Reduce Clip Size/Total Obligation during Volatility | Reduce market maker obligations during periods of high volatility (e.g. 0.6 MW clip size, 1.2 MW obligation) when volatility spikes) | Allows market makers to maintain presence during high volatility.<br><br>Reduces risk exposure for market makers.<br><br>Can help prevent complete liquidity withdrawal. | May result in reduced overall market depth.<br><br>Increased spreads. |
| 5. Flexibility in Failing Criteria | This option allows for some leniency in assessing market maker performance, considering overall session | Acknowledges that minor, brief failures shouldn't constitute a breach. | Could be perceived as lowering standards. |

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| | performance rather than isolated failures. Failure is not binary, e.g. if we fail on 1 contract for 1 second, this could still be passed, as liquidity effectively provided for the session | Can encourage continued market making in challenging conditions.<br><br>More realistic approach to assessing market maker performance under extreme market events. | |
| 6. Wider Spreads extreme volatility | 5% or 10% or more, when prices spike | Helps market makers manage risk during volatile periods.<br><br>Can encourage market makers to stay in the market.<br><br>Reflects increased risk and uncertainty during volatile periods. | Increases trading costs for market participants.<br><br>May lead to reduced liquidity for while relief is active. |