14 April 2025

Submissions
Electricity Authority

By email: market.making@ea.govt.nz

Expiry of Urgent Code regarding market making under high stress conditions

Meridian appreciates the opportunity to provide feedback on the Authority's consultation paper on the expiry of urgent Code provisions regarding market making under high stress conditions.

In Meridian's opinion:

- There were clear deficiencies with the Authority's ad hoc implementation of market making relief under urgency in 2024.
- However, the Authority was right to try to address the risk identified.
- The Authority now seems to have backtracked and no longer considers volatility a risk to price discovery and enduring market making – this conclusion does not stand up under scrutiny.
- In the absence of market stress provisions, there remains a risk that market making will not endure through volatile periods in future.
- It would be preferable to have well-designed market stress provisions that avoid the need for future ad hoc interventions and provide for enduring price discovery and lower market making costs.
- A well-designed market stress provision would allow the widening of spreads to 10 percent for specific products (as opposed to all products) that exceed a defined volatility threshold.

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- In the longer term, the Authority should also progress its 2020 decision to transition to commercial market making. This would enable the Authority (and beneficiaries of the market making service) to properly balance the costs and benefits of market making obligations with or without market stress provisions.

These points are addressed further below.

Deficiencies with the ad hoc implementation of market making relief in 2024

It is remarkable for a regulator to tell market participants to ignore the rules it has made because they are not fit for purpose. That is what occurred on 12 August 2024 when the Authority told market makers that it would not enforce the Code.[1] The Authority finally amended the Code under urgency on 12 September 2024, by which time market conditions had become less volatile, meaning the market stress provisions were never triggered. This was not best practice. Ad hoc changes by a regulator during a time of stress do not result in good outcomes for market participants or consumers. However, the Authority was right to identify and address the underlying risk. In Meridian's opinion, the Code should be amended to ensure that market making will endure future periods of volatility like that experienced in August 2024. Periods of volatile ASX prices are highly likely to recur as the electricity market manages the gas shortage and transitions to an increasingly renewable generation base.

The available evidence does not support the Authority backtracking from the concerns it identified in August 2024

The current consultation paper effectively says the Authority need not have taken any of the actions it did in 2024. The consultation paper states that: "If the urgent Code were to expire, it would be the Authority's expectation that the exemptions available, 5 exemptions in a rolling 20-day window, and the additional exemptions taken before facing mandatory provision (2 in a 90-day window), are sufficient for market makers to manage their risk appropriately." The implication is that the Authority, with the benefit of hindsight, believes it should not have taken any action in Winter 2024. The Authority points to new information to explain this inconsistency:

- The urgent Code provisions have never been triggered so the impact is unknown, but the Authority looks at historic data to suggest there may be a negative impact on

[1] The Authority in its haste also neglected to transparently inform all market participants of this change.

liquidity if the urgent Code amendment provisions are activated and spreads increase from 3 percent to 5 percent. There are many drivers of ASX liquidity, not only the level of market making spreads, so any correlation here does not necessarily suggest causation. Furthermore, any costs associated with a reduction in liquidity due to the activation of wider spreads would need to be compared with the benefits associated with reduced market making costs and ensuring a more reliable market making service with less risk of cascade failure during times of volatility.

- The Authority states that it is undertaking work to address security of supply in the coming winters. It would be naïve of the Authority to think that its actions mean no periods of ASX volatility will occur in future. Security of supply remains an immediate concern given gas availability, dry years will inevitably recur, and there are various other unforeseeable disruptions that could significantly increase ASX volatility.
- The Authority states that market conditions did not impact trading behaviour as much as previously thought. In short, the Authority considers it likely that regulated market makers will continue to provide the service (even at enormous cost) because their motivation to comply with Code obligations is not exclusively financial. Meridian is conscious of the reputational risks associated with Code breaches, however, there is a limit to how much financial pain any market maker will be willing to endure.
- The Authority states that the use of exemptions has changed and that "with the lessons learned from Winter 2024, we would expect market makers to manage their exemptions carefully, thereby providing a stronger buffer against periods of market stress." Meridian cautions against reading too much into the data on the use of exemptions. The sample period and supposed behaviour shift are not significant enough to enable reliable conclusions. Critically, even if behaviour around the use of exemptions has changed, exemptions can only ever provide relief from very short-term volatility. In the absence of market stress provisions, any period of sustained volatility will again give rise to the risk that market makers could cease to market make after all exemptions have been used, due to the financial losses they might sustain. As the consultation paper notes, this could lead to a cascade failure across all market makers. Such severe disruption would have a far greater impact on liquidity and price discovery than the implementation of market stress provisions.

In Meridian's opinion the available evidence does not support the Authority backtracking from the concerns it identified in August 2024. There is still a very real risk that ASX volatility in future could lead to a reduction in market making services with sever consequences for liquidity and price discovery. The potential costs of such severe disruption are likely to far exceed the relatively small costs associated with allowing the widening of spreads at times of high volatility.

Design of enduring market stress provisions

Meridian supports Option 3 in the consultation paper to modify the urgent Code amendment provision. To do this, the urgent Code amendment could be rolled over in the short-term while work is undertaken to develop well-designed market stress provisions that:

- avoid the need for future ad hoc interventions (and the associated harms);
- provide for reliable and enduring price discovery through times of volatility;
- reduce market making costs and the associated costs to consumers (for example through levy appropriations); and
- ultimately, deliver a more reliable market making service for the long-term benefit of consumers.

Well-designed market stress provisions would maintain liquidity and price discovery through periods of volatility while reducing the costs of market making. Without such provisions there will be an ongoing risk that market makers (both commercial and regulated) may be unable to sustain market making at times. Furthermore, future contracts for commercial market makers are likely to be higher priced, necessitating an increased levy appropriation by the Authority and costs to consumers.

Meridian suggests a trigger for market stress provisions should be based on a measure of volatility rather than a price level. Volatility is the real driver of market making costs. The appended report by Sapere Research Group proposes “that an enduring VCM [volatility control mechanism], based on the level of volatility, is introduced into the Code if a cost benefit analysis using the CBA framework applied in previous interventions supports it.” The Authority’s consultation paper discounts this option due to a risk that volatility triggers would result in false positives, such as increases in price at low price levels. However, there are ways to design a volatility trigger that would mitigate this risk. For example, the trigger could be based on:

- a number of consecutive days involving day-to-day changes in daily settlement prices exceeding 10 percent; or
- a volatility measure like the standard deviation of log returns on the daily settlement prices of futures products but with say a five day moving measure to smooth out any false positives or single day moves (which could be managed through exemptions); and/or

- by retaining some discretion for the Authority to trigger relief – although Meridian agrees that this should be minimised, for example by having a presumed triggering based on a measure like one of those proposed above that will activate the stress provisions unless the Authority intervenes in defined exceptional circumstances.

The widening of spreads allowed under the urgent Code provisions would in Meridian' opinion provide some limited benefits in terms of reliability and reduced costs of market making. However, as per the appended report by Sapere, the Authority should undertake analysis to identify a 'goldilocks' spread that would balance the objectives of the market making scheme with the incentives for market makers to continue to provide the service. A spread of 3 percent is too tight during periods of high price volatility, while spreads of 15 percent appear too wide to still deliver the benefits of having a market making scheme in place. The aim would be to strike the optimal balance between:

- the costs of market making;
- level of reliability (risk of service cessation); and
- level of service (liquidity level and efficacy of price discovery).

In Meridian's opinion, the optimal level for spreads under a well-designed market stress provision is likely to sit at around 10 percent.

Meridian would also recommend that triggers and widening of spreads occur for each ASX product, rather than across all products since there may, for example, be volatility in short-dated products that necessitates relief while prices of long-dated products remain less volatile.

We strongly recommend that the Authority considers Option 3 and builds enduring and reliable market stress provisions into the Code. Market stress provisions are the norm in many formal exchanges (currencies, bonds, money market, equities, futures and derivatives) to reduce costs, protect participants from undue volatility, and maintain continuity of price discovery. In Meridian's opinion, it would be in the long-term interests of New Zealand consumers for the ASX electricity futures market making regime to include similar provisions.

Meridian is concerned that if the Authority allows the current urgent Code amendment to expire, then we could see a repeat of the volatility experienced by the market in 2024 and the associated risks of reduced market making services, reduced price discovery, and poorly executed ad hoc interventions to address the situation.

Transitioning to a commercial market making regime would help in the long term

In the longer term, the Authority should also progress its 2020 decision to transition to commercial market making. This would enable the Authority (and beneficiaries of the market making service) to properly balance the costs and benefits of market making obligations with or without market stress provisions. In the absence of a more beneficiaries pay approach, free rider issues will prevail and the beneficiaries of market making will continue to advocate for a very high level of service, irrespective of costs.

In 2020 the Authority decided on enduring market-making arrangements that:

- transition, over a period of years, to an incentivised market making arrangement where market making services are performed by providers compensated on commercial terms; and
- ensures the integrity of market making services is maintained in the transition period through a combination of mandated market makers and commercial providers.

The Authority stated that the transition period will likely take several years. However, since the introduction of the first market maker there has been no further update on progress from the Authority.

Recovering the full costs of market making services through the levy (or ideally ASX fees) would allow the beneficiaries of market making to influence the level of service through the annual levy consultation process. Beneficiaries and the Authority would therefore be far better placed to determine what is an efficient and cost-effective level of market making services (including what level of market stress relief to provide). The Authority would gain information on the trade-offs between service levels, reliability, and cost during the procurement process for commercial providers.

The current consultation paper states that the Authority will prepare a broader review of the role that market making plays in the overall New Zealand electricity market and that it anticipates releasing this in the second half of 2025. Meridian supports a wider review and encourages the Authority to focus on the balance between cost, reliability and service levels and how increased commercial market making would help the Authority to strike that balance – in respect of both market stress provisions and other aspects of the service.

Meridian has consistently supported steps to make market-making more sustainable and is not opposed to a strict market making service without stress relief, as long as market making is procured on a commercial basis and the costs of the service are collectively borne by the beneficiaries of market making who have determined that the benefits of a strict service outweigh the costs.

Please contact me if you have any queries regarding this submission.

Nāku noa, nā

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Appendix: Sapere: Mandatory market making under high stress conditions