Information sheet

Lodging a Hedge Settlement Agreement

This information sheet outlines the key requirements for lodging a Hedge Settlement Agreement with the Clearing Manager, and how interested parties can make use of such agreements.

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Glossary[1]

ASX	Australian Securities Exchange Limited
Authority	Electricity Authority
CfD	Contract for differences
Clearing Manager	The person appointed by the **Authority** to act as the **Clearing Manager** under the **Code**. As at July 2011, NZX Limited acts in this role.
Code	Electricity Industry Participation Code 2010
Participant	This term is defined in the **Code**. Essentially, the term includes any electricity retailer, purchaser, generator, distributor or any electricity user connected directly to the grid.
Payee	A person to whom the **Clearing Manager** must pay an amount on settlement day
Payer	A person who must pay an amount to the **Clearing Manager** on settlement day

[1] Terms in bold throughout this document are defined in the glossary.

What is a Hedge Settlement Agreement?

A **Hedge Settlement Agreement (HSA)** is an agreement between two market **participants** in favour of the **Clearing Manager**. It relates to an underlying "hedging arrangement" between the two **participants**. When an **HSA** is lodged with the **Clearing Manager**, its effect is that:

(i) any amount that one participant must pay to a second participant under the hedging arrangement must instead be paid to the **Clearing Manager** by 2pm on settlement day, and

(ii) that the **Clearing Manager** must then pay that amount to the second participant by 4:30pm on settlement day; and

(iii) that the **Clearing Manager** will take into account the expected payments under the hedge arrangement when determining the required prudential levels for each participant.

Every hedge settlement agreement must be approved by the **Authority** before it is lodged with the **Clearing Manager**.

What types of HSA can be lodged with the Clearing Manager?

The Authority will approve an **HSA** only if it is on the terms set out in schedule 14.5 or if it is in some other form that has been approved by the **Authority**.

Schedule 14.5 provides a template for an **HSA** for use when the underlying hedging arrangement is a contract for differences (**CfD**).

If a participant seeks to lodge a HSA that is not in the terms set out in schedule 14.5, the **Authority** will consider whether the **Clearing Manager's** systems are capable of recognising the **HSA** and incorporating it into calculations of required prudential levels. The clearing and settlement functional requirements in the **Clearing Manager's** service provider agreement[2] require the **Clearing Manager** to calculate hedge settlement amounts, but only in relation to **CfDs**.

A **CfD** is a contract between two parties (A and B) for A to pay to B the difference between the spot price at a particular location and an agreed price ("strike price") for an agreed quantity of electricity (the nominated quantity) over a period of time (the

[2] Refer to schedule 3, section 7, item IN-050 of the **Clearing Manager** Service Provider Agreement, available at http://www.ea.govt.nz/industry/mo-service-providers/clearing-market-operation-service-provider/.

contract duration). If that difference is negative, then B must pay A the amount. The nominated quantity is agreed in advance for each half hour of the contract duration. The party who is obliged to pay, and the amount to be paid, are not known until final spot prices become known.

The template provided by schedule 14.5 allows for different quantities and strike prices to apply to each trading period. The template also provides for varying approaches to force majeure provisions.

The functional requirements do not require the **Clearing Manager's** systems to calculate hedge settlement amounts in relation to hedging arrangements that are not standard **CfDs**. Consequently, a financial contract that only pays differences in one direction (an option contract) cannot yet be accommodated by the **Clearing Manager**. Consequently, the **Authority** cannot at present approve an **HSA** in relation to an option contract. Similarly, the **Authority** cannot at present approve an **HSA** in relation to a participant's holding of **ASX** New Zealand electricity futures contracts (or related **ASX** options contracts).

What effect will an HSA have on my settlement amounts?

A **participant** will usually receive two invoices from the **Clearing Manager**: a **payer** invoice requiring the **participant** to pay a certain amount by 2pm on settlement day, and a pro forma **payee** invoice specifying the amount that the **Clearing Manager** expects to pay to the participant by 4:30pm on settlement day.

If a **participant** *owes* an amount in accordance with a hedging arrangement that is subject to an **HSA**, the **Clearing Manager** will detail that amount on the **participant's payer** invoice, and the **participant** must pay the amount to the **Clearing Manager** by 2pm on settlement day along with any other amounts specified on that invoice.

If the **participant** is *entitled to receive* an amount in accordance with a hedging arrangement that is subject to an **HSA**, the **Clearing Manager** will detail that amount on the **participant's** pro forma **payee** invoice, and the **Clearing Manager** will (assuming sufficient funds are available) pay the amount to the **participant** by 4:30pm on settlement day along with any other amounts specified on that invoice.

What effect will an HSA have on my required prudential level?

An **HSA** between two **participants** will affect the **Clearing Manager's** expected financial exposure to those **participants** over the prudential period.[3] Consequently, the **HSA** may affect the required level of prudential security for those parties.

In broad terms, a **participant** with a net purchase position will be required to provide a minimum level of prudential security covering the credit period. If spot prices are high, the required prudential level will be correspondingly high. If spot prices are low, the required prudential level is lower. If the **participant** enters a **CfD** that covers their net purchase position and lodges an **HSA** in relation to that **CfD**, their required prudential level will exhibit less volatility as price changes. If spot prices are high, the **HSA** will act to restrain any increase in the required prudential level. If spot prices are low, the **HSA** will act to restrain any decrease in the required prudential level.

[3] The prudential period is normally a period of 57 or 58 days. It begins on the first day of the month that is due to be settled on the next settlement day. It ends 7 days after the next settlement day.

How do I lodge a Hedge Settlement Agreement?

Decide whether to lodge HSA during contract negotiations

An **HSA** may impact on the prudential obligations of both parties. Therefore, the question of whether a hedging arrangement will be subject to an **HSA** should be discussed by the parties as part of the contract negotiation.

Fill out the form in Schedule 14.5 and provide all necessary information

The template in Schedule 14.5 should then be filled out. This will require a certain amount of information to be presented. This is discussed further in the next section.

Strike out irrelevant clauses

The parties must strike out the optional clauses in the template that do not apply.

Attach any additional provisions

Contact the Clearing Manager about any extra info required

If there are any additional conditions or clauses that should be included in the **HSA**, these should be written up and attached to the form. It may be beneficial to talk to the **Clearing Manager** about any additional information that may be required to accommodate such additional clauses, as any missing information may delay the **HSA** approval.

Both parties sign and date the HSA form

The **HSA** form must be dated and signed by both parties.

Submit the HSA to the Clearing Manager.

The Clearing Manager will take up to 10 days to process the HSA

Once the form is signed and all necessary information is included, it can be sent to the **Clearing Manager**. The **Clearing Manager** will pass everything on to the **Authority** which will need to approve the **HSA**. Once approved, the **Clearing Manager** will input the details of the **HSA** into their system. This whole process will take around 10 days, assuming everything is in order. This time lapse should be considered when setting the **HSA** start date.

Clearing Manager to confirm or request additional info

The **Clearing Manager** or **Authority** will inform you when the **HSA** has been processed, or contact you if there are any problems with the submission, or if further information is required.

What information do I need to lodge an HSA?

Lodging an **HSA** will require a **participant** to complete the template provided in Schedule 14.5 of the **Code**, by providing the information indicated on the form in square brackets. This information should be provided in hard copy. The information must specify:

- which party is the Floating Price Payer and which is the Fixed Price Payer;
- the day and hour at which the contract begins and ends;
- the **grid exit/injection points** that will be used to determine the floating price;
- the MWh quantity per trading period and the $/MWh price for each relevant **GXP/GIP**. This information can be submitted in a separate table or attachment;
- the addresses of both parties so that the **Clearing Manager** may notify either party in writing of any future requirements relating to the **HSA**.

Participants may tailor the **HSA** while remaining within the template provided by schedule 14.5 by stating:

- whether a force majeure clause is to be included in the agreement. There are further obligations on the parties under the **HSA** if such a clause is included;
- the geographical location that will be used to determine the meaning of "Business Day" in section 1.3 of the 1993 ISDA Commodity Definition for the purpose of calculating the amount payable under the **HSA**;
- what provision is made for an alternative **grid exit/injection** point to be used to determine the floating price if and when the preferred **GXP/GIP** is disconnected.

Additional clauses may also be included beyond those already set out in Schedule 14.5, although these will need to be considered by the **Authority** on a case by case basis before approving the **HSA**.

The **Clearing Manager** may require additional information to be submitted in a prescribed format. This is particularly likely where additional caveats or conditions are included, beyond that already allowed for in Schedule 14.5. For example, if an

HSA is conditional on another contract being in place, the **Clearing Manager** may require some information on that contract.

What do I do if I want to cancel an HSA?

Just as both parties to a hedge contract must agree to lodge an **HSA**, both parties must agree to cancel an **HSA**. To cancel an **HSA**, the **Clearing Manager** will have to be notified in writing by either party, with the consent of the other party, and a cancellation date noted.

The **Clearing Manager** must be given at least two days notice of any cancellation. The **HSA** will remain in effect up to and including midnight on the cancellation date, and any future settlement will account for this.

What else do I need to know?

Under the **Code**, parties to an **HSA** are obliged to inform the **Clearing Manager** or the **Rulings Panel** if an **HSA** is no longer valid or enforceable for any reason. Parties should take care to understand their rights and obligations under any **HSA** before agreeing to it.

If you have any questions or require further detail on lodging a **Hedge Settlement Agreement** please contact the **Authority** on 460 8860 or info@ea.govt.nz.