meridian

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Submissions

Electricity Authority

By email submissions@ea.govt.nz

Improving the Opportunities to Hedge New Zealand Electricity Prices

Meridian welcomes the opportunity to submit on the Electricity Authority's paper "Improving the Opportunities to Hedge New Zealand Electricity Prices". Meridian supports the development of a well-functioning hedge market for New Zealand electricity prices, and is continuing to work with the Australian Securities Exchange (ASX) to achieve this goal.

Meridian acknowledges the Authority's proposal to allow more time for the market to work with the ASX to improve the functioning of the electricity hedge market. We support a continuation of this voluntary approach to encouraging liquidity, noting that the adoption of prescriptive regulatory amendments could limit innovation and create additional risk for market participants.

More detailed responses to the consultation paper are set out below. If you have any queries regarding this submission please contact me.

Yours sincerely

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1. **Do you agree that the options considered by the Authority cover the range of possibilities that should be considered? Are there other options that should be considered?**

Meridian is comfortable with the range of options considered. However, we believe that a key contributor to improving hedge market liquidity will be to encourage a broader range of participants in the market, beyond just the major generators. As such, we believe the Electricity Authority should continue to engage directly with other potential participants (e.g. financial institutions, large consumers) to identify their perceived barriers to participation in the market and alternative options to address these barriers.

Meridian believes that the development of an intra-island Financial Transmission Rights (FTR) scheme would also support development of the ASX hedge market. Where an existing or potential participant is physically located away from the available hedge market nodes of Otahuhu and Benmore, the effectiveness of hedging can be diminished by the price differentials which arise between the hedge market nodes and the nodes at which the participant purchases electricity. For example, even if the Tiwai Point aluminium smelter were to purchase hedges at Benmore, it would still be exposed to future price differentials between Benmore and its local pricing node (TWI2201).

The existence of an intra-island FTR scheme would allow participants to better manage this locational price risk and, in combination with the ASX hedge market, assist in reducing the participant's exposure to future price volatility. An intra-island FTR and the hedge market are therefore likely to be mutually reinforcing.

2. **Do you agree that offering different products through the ASX platform could help to encourage more participation, or would the requirement to provide initial margins and daily margin calls continue to deter new entrants?**

Meridian's view is that the key barriers to entry to the ASX electricity hedge market for smaller players are credit and prudential requirements. While Meridian is not opposed to reducing contract size, we believe (as suggested by the Authority) that reducing contract size on its own is unlikely to greatly encourage participation of smaller players. Rather, our view is that the Authority should focus on reducing the burden of prudential requirements, and promoting the participation of intermediaries to act on behalf of smaller players. In terms of product, Meridian believes the focus should be on development of the base futures contract and associated options which are yet to trade on the exchange.

3. **Do you agree that tightening the market-maker agreements would encourage participation, deliver more active hedge trading, and provide a more robust view of forward electricity prices?**

Meridian views tightening market maker arrangements as a potentially effective means of promoting hedge market liquidity. As a major generator and retailer, we are working with the ASX to ensure that market maker agreements are in place and are making an active contribution to hedge market trading. We believe all of the "big 5" generators should be subject to such agreements.

However, we believe the implementation of such agreements should continue to be a matter agreed between individual participants and the ASX. We view the codification of such agreements as entirely inappropriate given the potential to expose market makers to manipulative trading strategies and increased risk, especially in relation to requirements around re-loading bids.

While it was not explicitly detailed as an option in the consultation paper, Meridian would not want to see intermediaries take on the role of market maker for major generators (as opposed to being market makers in their own right). Each market making agreement is in effect a commercial arrangement between the ASX and a participant, and contains conditions specific to that counterparty's portfolio risks. Assessment of these risks and the design of appropriate conditions is best left to the market makers themselves, rather than third parties motivated by different incentives.

4. **Do you agree that doing more to ensure prudential arrangements for the spot electricity market acknowledge ASX electricity futures would encourage participation in the futures market?**

Meridian believes the current credit and prudential requirements are a major barrier to encouraging a broader range of participants in the ASX hedge market. Optimising credit arrangements across both physical and financial markets will minimise the overall collateral required, reducing this key barrier to entry, particularly for smaller participants.

Meridian notes that the Authority is undertaking a review of settlement and prudential arrangements, incorporating advice from the Wholesale Advisory Group. Due to the complexity of these issues, we consider this separate review process is the appropriate forum for reaching conclusions on the details of any potential changes.

5. **Do you agree that there is a need to provide higher quality information to all participants in order to encourage participation, deliver more active hedge trading, and provide a more robust view of forward electricity prices?**

In general, Meridian supports the provision of relevant market information to all participants as a means of encouraging hedge market liquidity. In particular, we would view the dissemination of information on fuel prices and fuel reserves as likely to promote a more even playing field which in turn will encourage greater confidence and participation in the market. We believe all market participants should be subject to equivalent disclosure requirements, and note the current asymmetry of information availability between hydro and thermal fuel data. This was illustrated by the outage at the Maui gas platform in December 2010, which substantially impacted prices but was only known in advance by some parties.

While we support the principle of disseminating information on the market's total contracted position, any requirements should clearly not go so far as requiring the disclosure of the commercial terms of individual contracts.

6. **Do you believe there is a market failure justification for it using levy payers money to buy access to futures and options prices for all interested parties either on a real-time basis or a 20-minute delayed basis?**

No. The potential group of futures market participants is broarder than the group of levy payers. As such, we believe that the decision to purchase and the cost of accessing such information should be borne by individual participants.

7. **Do you agree that the intent of the 3,000 GWh target has largely been achieved because of the indexation of the VAS contracts?**

The ASX futures market represents one aspect of a well-functioning hedge market, and Meridian is working with the ASX to ensure the market develops successfully. Meridian agrees that the indexation of the Virtual Asset Swaps (VAS) to the ASX futures market is a positive step in encouraging a liquid hedge market. However, we believe that other risk-management mechanisms, including bilateral forward contracts, should also be recognised when considering overall hedge market liquidity.

Furthermore, Meridian believes a key indicator of a well-functioning hedge market is the *breadth* of market participants, i.e. the number and range of entities trading. The participation of entities without a physical position in New Zealand's electricity market, such as financial institutions, should be seen as an important measure of the strength of the market. The provision of information on the breakdown of participants (e.g. market makers versus others) in the hedge market would assist all parties gauge the market's strength.

8. **Do you agree that further progress is required to meet the requirements of s42(2)(g) of the Act?**

Meridian is interested in having access to a functioning hedge market which allows us to effectively manage the inherent risk in being a hydro generator and retailer. We are working with ASX to ensure that such a market is realised. However, we re-iterate our view that the entire range of options to achieve a functioning hedge market need to be available if this goal is to be accomplished in an efficient and effective way.

9. **Do you agree that more time should be allowed for the generator-retailers to continue working with ASX to develop liquidity?**

Experience in other jurisdictions has demonstrated that electricity hedge markets develop incrementally. While it is useful to establish milestones to review progress and consider further options for encouraging market development, it is vital that flexibility is retained in relation to how greater liquidity is achieved. We believe as much time as possible should be allowed for the major players and ASX to work together to develop the market. We oppose any premature Code changes which will restrict the ability of the market participants and the market operator to adopt the most suitable and sensible solution to increasing liquidity. This is particularly so given the general consensus of the ASX User Group that the fundamentals of this new futures market are strong, and that time will be required to see its development. It should be noted the User Group also includes a number of major financial intermediaries who share and endorse this view.

Furthermore, we note the high degree of uncertainty in the current economic environment, which will naturally lead to a lower risk appetite amongst existing and potential market players. As such, development of the hedge market can be expected to remain cautious.

10. **Do you agree that the Authority should reconsider amending the Code if progress towards a standardised market-making agreement is too slow, or if it considers that the objective of a robust forward electricity price curve (including 3000 GWh target) has not been met by 1 January 2012?**

As above, we consider that as much time as possible should be allowed for market players to work together to improve liquidity on a voluntary basis. Such an approach maximises flexibility and innovation. Code amendments should only be considered if industry efforts result in a demonstrable lack of progress.

11. Do you agree that the draft Code amendments contained in Appendix 2 would be likely to enhance the performance of the electricity futures market sufficient to provide for a robust forward electricity price curve (while noting that the Authority's preliminary view is to not make Code amendments at this point in time?

Meridian is opposed to Code amendments at this stage, and considers it too early to make detailed drafting comments. Should the Authority subsequently deem it necessary to amend the Code, further detailed consultation should be undertaken with market participants.

12. Do you agree that allowing the generators to work with ASX to develop the market-making arrangements (with the possibility that Code amendments might be required later) is likely to deliver a positive net benefit relative to a counterfactual of making Code amendments now?

Yes. Meridian considers that as much time as possible should be allowed for the generators to work with ASX to improve market liquidity on a voluntary basis. As above, we oppose any premature Code changes which will restrict the ability of the market participants and the market operator to adopt the most suitable and sensible solution to increasing liquidity.