11 Chews Lane
PO Box 10568
The Terrace
Wellington 6143
New Zealand

Genesis Power Limited
trading as Genesis Energy

Fax: 04 495 6363

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Tim Street
Electricity Authority
2 Hunter Street
WELLINGTON

By email: submissions@ea.govt.nz

Dear Tim

Market Making Agreement CBA

Genesis Power Limited, trading as Genesis Energy, welcomes the opportunity to provide feedback to the Electricity Authority ("the Authority") on its information paper "Cost Benefit Analysis – Market Making Obligations" dated 21 November 2011.

Genesis Energy welcomes the Authority's conclusion that intervention to require large generators to enter into prescribed market making agreements is not warranted. We agree that the best course of action for the Authority is to simply maintain a watching brief on electricity futures market metrics such as bid-ask spreads and trading volumes.

We also welcome the Authority's initiative of publishing a cost benefit analysis information paper for this matter. The paper highlights the difficulties of obtaining accurate empirical information, but is nonetheless useful in setting out the nature and the indicative scale of the costs and benefits that may arise. The paper helps to explain the logic underpinning the Authority's interest in the performance of electricity futures markets and provides insights into how the Authority expects the overall electricity market to evolve.

We provide a number of comments below on aspects of the Authority's assessment and trust that these will prove useful should the Authority need to refine its assessment in future.

Reference	Comment
Footnote 2 (page 1)	We agree that there may be numerous reasons why parties have been reluctant to voluntarily enter in market making agreements for New Zealand electricity futures, but we think it is unhelpful for the Authority to suggest that protecting hedge market rents is a primary reason. It is not clear to us that there are material hedge market rents to be protected, or that generators would be in a position to sustain any such rents in the various markets for electricity hedge products given the range of alternative suppliers and strategies available to purchasers. We agree with the Authority that "most markets do not find it necessary to compel parties to act as market makers", but it is also true that most markets take time to develop. This means that the benefits of being a market maker change over time and may not be particularly attractive to participants during the early phases of market development.
2.1.1	The Authority observes that "…many participants believe that systematically purchasing forward contracts will result in higher prices on average than buying electricity on the spot electricity market" and seems to suggest that this is a problem. Our expectation is that forward contract prices in an efficient electricity market should be more costly over the long run (though less risky) than purchasing from the spot market. This reflects that a forward contract transfers risk between parties. The risk transfer price for any given contract depends on the specific risks and is influenced by, for example, term, load profile, location and creditworthiness. We agree that competitive pressure also has a role to play in the size of the margin between spot prices and forward contract prices, but competition will not eliminate the cost of transferring risks. We note that a margin between futures prices and over-the-counter (OTC) prices should also be expected to persist due to the higher prudential risk (as well as any other contract-specific risks) associated with OTC contracts.

Reference	Comment
	Finally, the Authority's own intervention in spot market price setting last year has itself substantially undermined confidence in hedge markets by showing that regulatory lobbying to alter commercial outcomes can be a viable and successful strategy obviating the need to hedge.
2.1.6 (a)	We agree that a deeper and more liquid futures market improves price certainty and confidence in forward prices. However, we caution against overestimating how much the futures market can help overcome the inherent uncertainty in New Zealand's electricity market. Even a fully mature electricity futures market should be expected to frequently exhibit significant shifts in contract prices as new information emerges, particularly with respect to hydrology. Floods and droughts develop and flow through to electricity prices relatively quickly.
3.2	We agree that a robust hedge market should have a positive effect on retail competition. However, we suggest that the Authority should focus on the threat of entry or expansion rather than on the number of retail participants. We also note that it would be plausible for increased competitive pressure to result in consolidation and hence fewer retail market participants (for example, because participants are forced to pursue scale efficiencies or because inefficient participants cannot compete).
3.3	We are sceptical that more robust futures contract pricing could have a meaningful impact on fuel management decisions. Near-term hydrological information is already incorporated into the opportunity cost assessments that influence the formation of spot prices, while prices for out quarters are always likely to be based on an assumption of normal hydrological conditions (and are unlikely to influence hydro storage decisions in any event).

Reference	Comment
4.1	The Authority's analysis of costs omits the costs that may arise from distorting the allocation of capital. Mandatory market making forces firms to allocate capital to managing the risks associated with increased exposure to the electricity futures market. This has an opportunity cost (given that capital is scarce) and may alter the firm's overall risk exposure.
4.2.5 (a)	We agree that it is important to treat similar entities on a similar basis. One of the difficulties with mandating market making is that the Authority is forced to discriminate on the basis of size rather than allowing firms to make their own decisions regarding the costs and benefits of market making and their appetite for the associated risks and opportunities.
4.2.5 (c) – (d)	We do not agree that access to physical assets can be used to practically manage the financial risks of market making. The financial risks of market making crystallise as daily margin calls that must be met by cash settlement. Ownership of fixed assets does not directly help to manage this form of risk.
4.3	We agree that imposing market making obligations via the Code would decrease flexibility for covered firms and note that market making agreements are typically reviewed and refined annually. We note that a mandatory obligation that applied to generators over a certain size may, in the extreme, have distortionary effects on decisions regarding firm scale and investor risk exposure.
5.2.2	We appreciate that assuming a linear relationship between a reduction in spreads and an increase benefits simplifies the analysis, but we expect that the relationship is not actually linear. Rather, we expect that most benefits occur if the spread is between 5% and 3% and that further tightening is not significantly more beneficial.

Reference	Comment
5.2.8	The Authority's analysis at this point should focus on the spread rather than on the number of market makers. For example, there would be no benefit in mandating market making if two voluntary market makers were successfully producing a spread of less than 5% in practice.
6.1.1 (c)	The Authority suggests that it would assess "…whether observed spreads reflected genuine competition among market makers". We are unsure what is implied by "genuine competition." Notwithstanding comments from some market participants last year regarding "gentlemen's agreements", we wish to assure the Authority that Genesis Energy does not act contrary to competition law in any manner whatsoever.

If you would like to discuss any of these matters further, please contact me on 04 495 3348.

Yours sincerely

RW Parry

Ross Parry
Regulatory Affairs Manager

genesis ENERGY