New Zealand Steel Limited
Mission Bush Road, Glenbrook
Private Bag 92121, Auckland 1142
DDI +64 9 375 8393 | **M** +64 21 870629
E alan.eyes@bluescopesteel.com

19 December 2014.

John Hancock
Chair
Wholesale Advisory Group
C/- Electricity Authority
By email to wag@ea.govt.nz

Dear John

Submission on Wholesale Advisory Group Hedge Market Development discussion paper

Thank you for the opportunity to submit on this discussion paper.

It is important the WAG has an understanding of perspectives from the range of market participants. As a major user of electricity, NZ Steel requests an opportunity to speak to this submission.

Regards

Alan Eyes | New Zealand Steel
Energy Manager
Private Bag 92121, Auckland, New Zealand
Mission Bush Road, Glenbrook, New Zealand
T. +64 9 375 8393 | M. +64 21 870629
alan.eyes@bluescopesteel.com | www.bluescopesteel.com

1. Based on you experience, are there any other challenges to managing risk through the hedge market that the WAG has not indentified?

2 Do you agree with the assessment that the status quo is insufficient, and that some improvements are appropriate at this point in time? If so, please rank your preferred initiatives and provide your rationale for them

As identified in the report, the futures market in NZ is relatively immature[1]. This is borne out by the lack of liquidity[2] and low number of participants, particularly on the demand side [3].

While the WAG report references EA published and other material showing development of the hedge market, before proceeding to the next stage of work, it will be appropriate for WAG to reassess the degree of progress that has been made. Appendix E shows a market still heavily made up of market makers[4], and decreasing participation by purchases[5]. Where are we at on the continuum towards a mature hedge market?

Hedge market development initiatives need to focus on the end consumer. The EA is required to focus on the long-term benefit of consumers[6]. An efficient hedge market is a key requirement for an efficient electricity market. **The next stage of work by WAG needs to ensure market initiatives have end consumers in mind**. It will be necessary to encourage participation by generators, retailers, and speculators, to assist in achieving this end, BUT the outcomes need to benefit consumers, not necessarily other participants.

3 What is your view on the ability or otherwise to manage the different facets of price risk?

There is limited ability for consumers to manage price risk. (Equally important is the ability to manage volume risk ie derivates create volume risk). The complexity of the market, relative to the importance of electricity cost to individual consumers, means the vast majority are unable to participate. The end result is consumers take on FPVV contracts[7] which provides price certainty, but at a cost.

For those consumers who operate outside the FPVV regime, hedges are often not an attractive option and physical means, such as reducing load, are important ways of managing pricing risk.

4 Do you have any comments on the Energy Link analysis and its conclusions? What should the WAG take away from the Energy Link work?

While the Energy Link work has not been peer reviewed, it is ground breaking, at least in NZ, and adds substantially to the hedge market discussion.

NZ Steel conclusion from the Energy Link work:

1. An ASX pricing margin averaging 10% over spot is confirmed[8], (and other instruments tend to be more expensive).
2. It is understood this is considerably greater than other markets.
3. However, relative to risk, the Delta (insurance premium) is not out of line with Australia or other jurisdictions examined.

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[1] Page 22, para 4.2.1
[2] Appendix E, Fig. 23, page 109
[3] Appendix E, Fig 31, page 118
[4] Appendix E, Fig 34&35, pages 121/2
[5] Appendix E. Fig 33, page 120.
[6] EA website homepage.
[7] Page 72
[8] Appendix J, Energy Link report 1, pages 1&28

4. Given the significant insurance premium, and volume risk that goes with derivate products, hedges are not a preferred means of managing price risk for us as an end consumer.

The Energy Link conclusion seems to take the spotlight off sellers of hedges. WAG needs to investigate further the reason for a significant price premium. If there is real risk why is this? Is this a market design issue? Is there an underlying flaw with the spot market? Without these answers it is doubtful the hedge market will be attractive to informed consumers and alternative non-market means will continue to be sought to manage price risk.

In answering a question posed at the WAG briefing seminar, Greg Sise of Energy Link said that for industries there may be opportunities to plan production around quarters with negative deltas[9]. This would be an alternative to hedging.

5 What are your views on the WAG's indicative assessment of the broad initiatives that might improve the ability to manage different facets of price risk? Which, if any, of the initiatives discussed do you think would be worth pursuing?

Most have merit.

- Incremental advances such as addressing the infeasible price situation and alignment of forecast and actual price should be progressed with urgency.
- A day-ahead market has major ramifications and requires detailed work and consultation before this is advanced.
- A price cap would solve a number of issues including improved hedge market participation and pricing. While it may not fit with pure economic theory, it will be a pragmatic step forward dealing with issues the market has been unable to address.

6 Are there any other specific initiatives that could improve the ability to manage the different facets of price risk that you think should be considered?

7 What evidence is there to support the view that vertical integration may be creating a barrier to hedging by independent generators and/or retailers

8 Do you agree with the WAG's high-level assessment of options that might improve hedging opportunities available to independent generators and retailers? Which, if any, of the options discussed do you prefer or not prefer?

9 Are there any other specific options aimed at improving the hedging opportunities available to independent generators and retailers that you think should be considered?

10 What is your view on the importance of speculators and intermediaries in the hedge market? What factors do you think are limiting their involvement?

Speculators will assist increasing liquidity and developing the market. The fact they are not currently involved to any real extent is something the WAG need to further consider. The statement has been made that if there are higher than

[9] Energy News 11 Dec 2014, "Hedge market premiums may attract investors – Energy Link"

justified hedge prices, there will be an arbitrage opportunity. The spread seems to be there, why not the speculators? WAG needs to understand these dynamics.

Intermediaries can assist greatly in developing the market, particularly ASX products, by handling the management and compliance issues.

As per Question 2, WAG needs to keep to the forefront that development of the hedge market must ultimately be for the long-term benefit of consumers.

11 Do you agree with the WAG's high-level assessment of options that might improve liquidity in the hedge market by increasing engagement, and reducing barriers to participation? Which, if any, of the options discussed do you prefer or not prefer?

12 Are there any other specific options aimed at increasing engagement and reducing barriers to participation that you think should be considered?

13 Any other comments?
The WAG paper includes a number of ideas that if implemented will assist in development of the hedge market. However, we are not confident that these will lead to a step-change that will encourage participation for the benefit of consumers. We encourage the WAG to look beyond these incremental steps, and identify fundamental aspects impacting the hedge market. This may be a two-step process.