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John Hancock
Wholesale Advisory Group
Electricity Authority
2 Hunter Street
WELLINGTON

By email: wag@ea.govt.nz

Dear John

Submission on hedge market development

Genesis Energy Limited welcomes the opportunity to provide a submission to the Electricity Authority ("the Authority") on the Wholesale Advisory Group ("the WAG") discussion paper "Hedge Market Development" dated 11 November 2014. We consider the WAG discussion paper to be comprehensive and that it provides a good overview of the current hedging market.

In general, Genesis Energy endorses the WAG's view that incremental change to the current hedge market is appropriate and will deliver the desired outcomes. We also consider that any regulatory intervention should initially focus on the core products already traded, rather than adding additional complexity.

Whilst still at the early stage of policy development, Genesis Energy considers the paper to be a sound starting point for a hedging market development framework. Such a market development framework will guide the Authority, the WAG, market participants and service providers on adopting suitable market development options to ensure the market matures appropriately over time.

In regards to the specific issues that WAG considers in the paper:

- Genesis Energy agrees more liquidity would be beneficial for the New Zealand electricity futures market ("ASX Futures"). We suggest this can be achieved through improving market making in the ASX Futures and a smaller product size.

- We suggest ASX Futures should focus on improving the liquidity of existing products, especially peak products.

- The industry must focus on improvements across multiple trading channels.

- We support lowering the prudential requirement by establishing centralized margining.

We elaborate on these points below. Our specific responses to the consultation paper questions are found in Appendix A.

Supporting incremental approach to change

Any regulatory intervention in the hedging markets may have serious unintended consequences if not supported by robust assessment. This is because of the relatively long-term financial positions and the number of parties participating in the hedging markets – particularly in the ASX Futures. Therefore, Genesis Energy supports the WAG's approach to promote incremental changes to the hedging market rather than quick or substantial interventions. An incremental approach will provide participants with certainty to invest resources in the hedging markets, knowing the regulatory framework is unlikely to significantly change. Introducing changes gradually, and transparently, helps avoid unintended consequences by providing participants with the time to adapt.

More liquidity would be beneficial for the futures market

Genesis Energy considers there are a number of initiatives that may enhance liquidity in the market. We suggest that improving market making obligations, reducing the current ASX Futures product size, and focusing on existing traded products are the most cost-effective actions to achieve this goal.

<u>The first priority should be to extend the current market making agreement</u>

We consider there are three key reasons why extending the market making agreement should be the first priority:

1. More market makers would significantly increase the robustness and efficiency of price discovery in the ASX Futures market and provide more depth to both the bid and offer stacks.

2. The obligation to market make should be transparent and consistent. The current ad hoc voluntary scheme does not provide the certainty required for a more mature ASX Futures market.

3. A more transparent and well defined mandatory market making obligation will ensure a level playing field in the market. Currently the significant cost[1] of market making is met by only four participants. Such cost and responsibility should be shared by the industry.

We consider that a mandatory market making obligation is practical and effective in the current New Zealand context. Any mandatory obligation should be based on clear criteria to assess which parties are included. We suggest that a range of criteria are used for this, such as; generation capacity, load portfolio, volume of buy and sell activities and size of the entity. The WAG should consult with the industry further on the framework and criteria for these obligations.

Smaller size product is desirable for different market participants

Genesis Energy agrees with the WAG that smaller size ASX Futures products will be beneficial for the electricity market, and ultimately for consumers. We consider that the current 1 MW product is too large for small or new entrant retailers. Lastly, a smaller product will enable both retailers and generators to match their hedges more accurately to their actual exposure.

We are fully supportive of the proposition to reduce the ASX Futures product size to 0.1MW[2]. A 0.1MW product size will also be beneficial in matching the current FTR contract size. We understand the ASX Futures transaction fee is under consideration and that the ASX is considering structuring the fee proportional to any contract size reduction. In our view this move should be supported as it further lowers the barriers to entry for future participants.

Focus on existing hedging products

In our view, focusing on the liquidity of existing products is the simplest and most effective solution to develop the hedging market. This could be aided by two changes to the existing market arrangements:

1. Mandating market making in peak futures products will make accessing these important hedging products easier for all participants.

[1] Including but not limited to: staff cost, transaction fee, cost of open position, cost of mispricing and cost of managing credit exposure.

[2] The Authority's market commentary dated December 2014

2. Extending the number of available monthly contracts will give generators and retailers a greater ability to shape their book over the front months of the forward curve.

<u>Sophisticated products should be considered later</u>

In our view the current priority for the industry must be ensuring adequate liquidity for the set of existing products in the futures market. We suggest introducing more sophisticated products (such as options) should be considered at a later stage. This is because the skillset to trade and market make in options is very different to the skillset required for the existing futures products. There would be a significant additional cost imposed on market makers if options were included.

Multiple trading channels should continue to be encouraged

The multiple trading channels available all have an important place in the market. The WAG should continue to ensure there are multiple channels available in order to meet the needs of as many participants as possible.

Improve current prudential requirement by having centralised margining

Genesis Energy is fully supportive of centralised margining, as it will reduce costs for all market participants.

Co-ordinated approach to regulatory work programme

The Authority currently has work programmes planned that focus on improvements to the hedging markets, including looking at options for facilitating market making for ASX products. The Authority is also currently developing an issues and options paper that will consider the benefit of robust and transparent daily pricing of existing contracts and that will describe the high level options for achieving this. Those projects are to be consulted on early next year and are running in parallel to the WAG work program.

Whilst we understand the desire to move quickly on solutions that appear very clear and uncontroversial, from a process point of view we suggest that the proper policy development framework must still be followed. The Authority must be mindful to avoid any potential inefficiency of running multiple work programmes for the same initiative simultaneously, and also to minimise any confusion to the industry stakeholders.

If you would like to discuss any of these matters further, please contact me on 04 495 495 6357.

Yours sincerely

Daisy Shen
Regulatory Advisor

Appendix A: Responses to Consultation Questions

QUESTION	COMMENT
Q1: Based on your experience, are there any other challenges to managing risk through the hedge market that the WAG has not identified?	Please refer to cover letter.
Q2: 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.	We consider the current market is working and allows participants to sufficiently manage their risks. However, we also recognize many of the proposed changes would be good for the market in the longer term, to the benefit of all participants. Please refer to our cover letter for further detail. In terms of prioritisation, our ranking of the preferred initiatives is: 1. More ASX Futures market makers. 2. Reduce the ASX Futures product size. 3. Market making for peak products in the ASX Futures 4. Increase the number of monthly contracts in the market making, so rolling 4 to 6 monthly contracts (matching with the front two quarters) are available. 5. Increase the number of lots offered under market making from 3MW to 4MW in the quarterly contracts and from 2MW to 3MW in the monthly contracts. 6. Better education for participants. 7. Cross margining to lower the working capital requirements.

QUESTION	COMMENT
Q3: What is your view on the ability or otherwise to manage the different facets of price risk?	We have a reasonable capability to manage the different facets of price risk. We consider a more developed hedging market will allow us to manage our current portfolio better. It will be similar for other market participants.
Q4: Do you have any comments on the Energy Link analysis and its conclusions? What should the WAG take away from the Energy Link work?	We found the Energy Link analysis to be comprehensive and informative. The WAG and the market should find some comfort in this analysis as there are no areas where there is a clear mis-pricing of futures contracts to the advantage of some market participants over others. The Energy Link work reinforces that there a very large number of drivers of futures pricing and it is difficult to make simplistic conclusions about these products.
Q5: 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?	We consider short and medium term initiatives should be the focus. Once some of the short term considerations are addressed, long term aspects should be reviewed later. Please refer to our letter for further details.
Q6: 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?	No.

QUESTION	COMMENT
Q7: What evidence is there to support the view that vertical integration may be creating a barrier to hedging by independent generators and/or retailers?	We do not consider that vertical integration creates a barrier to hedging by independent generators and/or retailers. Liquid, open and accessible hedge markets are a valuable tool for vertically integrated utilities as well as new entrants. Therefore, we suggest the development of these hedge markets will continue to be actively supported by the large gentailers. Vertical integration can be a very effective hedging tool. We suggest new entrant generators and/or retailers might want to explore this themselves in the future.
Q8: 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	Please refer to our cover letter.
Q9: Are there any other specific options aimed at improving the hedging opportunities available to independent generators and retailers that you think should be considered?	Please refer to our cover letter.
Q10: What is your view on the importance of speculators and intermediaries in the hedge market? What factors do you think are limiting their involvement?	Please refer to our cover letter.

QUESTION	COMMENT
Q11: 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?	We broadly agree with the WAG's assessment. Please refer to our letter above for more details.
Q12: Are there any other specific options aimed at increasing engagement and reducing barriers to participation that you think should be considered?	No. We would like to re-emphasise the importance of participant education. This would be beneficial for the whole market and will further improve the sustainability of the market.