

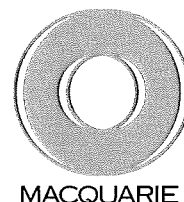
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Tuesday, 21 July 2015

By Email Only

Submissions
Electricity Authority
Level 7, ASB Bank Tower
2 Hunter Street
Wellington
New Zealand



Email: submissions@ea.govt.nz

Dear Sirs,

SUBJECT: New Zealand Electricity Authority Consultation “Enhancing trading of hedge products”

The Energy Markets Division of the Commodities and Financial Markets group of Macquarie Bank Limited (**Macquarie**) welcomes the opportunity to participate in the consultation process regarding enhancing trading of hedge products in the New Zealand Electricity Market (**NZEM**).

Macquarie is a participant in commodities markets globally, in particular electricity and gas markets. Macquarie actively trades in the Australian National Electricity Market (**NEM**), and has expanded its offering from being a derivatives provider to include bespoke financing facilities to retailers, tailored hedge solutions for generators, retailers and large consumers and prudential management tools across the NEM. Macquarie also holds electricity retail licences across the NEM, allowing it to provide electricity retailing services to large sophisticated consumers in Australia.

Macquarie has recently commenced trading in the NZEM with a view to providing a similar offering in New Zealand as our Australian business. As a result of the progress made in improving liquidity in the NZEM, Macquarie started participating in the NZEM and welcomes all efforts to further enhance liquidity and stability in the hedge market for the NZEM, and the broader electricity market as a result.

1. Question 1: Do you consider more authoritative market making arrangements to be necessary?

Macquarie considers more authoritative market making would ensure long term confidence and stability in the hedge market for the NZEM.

The NZEM is characterised by a high degree of vertical integration and few market participants. Prior to market making, the natural development of a hedge market for the NZEM had been slow with limited liquidity and transparency.

Market making has contributed to significant progress in the development of a hedge market for the NZEM in the last five years. This has greatly improved liquidity and transparency in this market, enhancing the development of the NZEM by enabling a number of new entrants into the NZEM.

2. Question 2: What are your views on the need for improved transparency around market making performance?

Macquarie believes transparency is required to ensure the market making initiative is working as desired and each market making participant is fulfilling their commitments. Regular reporting on market making performance would be beneficial to the aims of the market making arrangements, specifically, increasing competition.

3. Question 3: What market making metrics would be of most value to participants?

Macquarie believes that measures that increase market liquidity are beneficial to market participants and would most likely positively affect competition in the NZEM. The best way of achieving this, is by increasing the size of the required bid / ask (particularly on refresh).

4. Question 4: Do you agree the Authority should investigate improvements to the market making arrangements for the baseload futures products?

Agree – Macquarie sees the baseload futures contract as being the foundation of the electricity hedging market. Confidence in this product is essential for the development of the hedge market for the NZEM.

Improvements in market making arrangements promote long term confidence in the hedge market for the NZEM, and therefore a more competitive and robust electricity market as a whole by allowing new entrants to better manage risks.

5. Question 5: Specifically, do you agree that it should investigate tighter bid-offer spreads, greater volumes, and an extension of the monthly futures product by three to nine months?

Macquarie agrees with all of these proposals. As with our response to Question 3, Macquarie believes increased volumes are the most beneficial means to continue the development of the market and to increase competition.

6. Question 6: Do you agree that introducing a cap product would support the Authority's statutory objective?

The Authority has a statutory objective to *promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.*¹

Agree – As a cap product is seen to be an efficient risk management tool for participants to manage the risk of extreme prices and demand flexibility,

¹ Section 15 of the Electricity Industry Act 2010.

Macquarie considers that a cap product is in line with the Authority's statutory objective.

7. Question 7: What price making arrangements do you consider to be appropriate and/or necessary to support cap products?

It is Macquarie's view that liquidity on both sides of the market (i.e. bids and offers) is essential in the development of the NZEM and to improve competition.

Market participants require the ability to trade in and out of positions in changing market conditions. One-sided liquidity (i.e. offer only) is likely to limit the scalability of any cap product.

8. Question 8: Do you agree that the Authority should not further investigate market making arrangements for the peak futures product?

Macquarie considers increased granularity in hedge instruments is required to allow participants to better align hedges with underlying risks, and therefore incentivise new participants to enter the NZEM.

Hedging specific price risks with blunt hedge instruments (i.e. baseload contracts) results in basis risk which in itself is highly volatile and costly or difficult to manage.

Given this basis risk, a bid / ask of > 5% may be appropriate for market making peak products.

9. Question 9: Do you agree that liquidity in the option product is best supported by improving liquidity in baseload futures products?

Macquarie is of the view that liquidity in options products is best supported by improved liquidity in all hedge products (e.g. baseload, peak and cap products).

10. Question 10: Are there other products or price making arrangements that the Authority should investigate further?

At this stage Macquarie believes that were the Authority to investigate the products or price making arrangements mentioned above, that would be sufficient.

11. Question 11: What is your view on these approaches, and the extent to which they could be employed by the Authority, either alone, or as part of a mixed strategy?

Macquarie is of the view that long term confidence in the hedge market for the NZEM is key to achieving the Authority's statutory objective. Macquarie believes an effective means to accomplish this is through mandatory market making arrangements.

Under voluntary and incentivised arrangements, the effectiveness of the hedge market for the NZEM will always be subject to the willingness of participants to provide this service.

Whilst there may be some degree of confidence in this model currently and the voluntary arrangements have been somewhat effective to date, Macquarie considers substantial further progress can be made through a firmer approach.

Macquarie believes the most appropriate means to promote improvements in liquidity and therefore increased competition in the NZEM is to mandate market making arrangements. This would result in ongoing confidence in both the hedge market for the NZEM and the NZEM.

Yours faithfully

A handwritten signature in black ink, appearing to be 'AM', with a long horizontal line extending to the right.

Andrew McGrath
Executive Director
Head of Energy Markets Asia Pacific
Commodities and Financial Markets
Macquarie Bank Limited