

31 May 2019

Mary Ann Mitchell

By email

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Dear Mary Ann

The Authority's criteria for introducing mandatory market making on an urgent basis

In my discussion with Margaret Cooney (phone and email) on 3 May 2019 I was asked to set out the Authority's criteria for when it would intervene in the hedge market by urgently amending the Code to introduce mandatory market making. I understand that you are the appropriate person to correspond with since Margaret's departure from Flick Electric.

We have discussed this with our Board in light of recent events, particularly the wide bid-ask spreads and reliance on 'portfolio stress' by market makers for extended periods after spring 2018, and can provide you with the following feedback.

High level principles

At a high level the Authority will intervene if:

- a) the hedge market in general (including the market for ASX products) is no longer achieving the Authority's statutory objective. That is, if it does not promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers
- b) the criteria in the Act for urgently amending the Code were met. That is, that the Authority considers it necessary or desirable in the public interest that such an amendment was introduced.

The hedge market in general (including, but not limited to, the ASX market) supports achieving the Authority's statutory objective by providing several key outcomes. They are:

- a) providing a robust forward price curve
- b) enabling participants to efficiently hedge their spot price risk in the long-term
- c) enabling participants to efficiently hedge their spot price risk in the short-term (although this is relatively less important than the other two outcomes).

The Authority will consider intervening if the outcomes listed above are not being achieved to a satisfactory level (taking into account their relative importance).

Intervention in market making arrangements specifically

Whether or not any specific aspect of the hedge market is performing in a satisfactory manner is inevitably a question of judgement in the specific circumstances at a point in time. As such the Authority will not set specific pass/fail criteria.

However, a factor we would consider is the performance of market makers against their key obligations under their arrangements with ASX. That would include:

- a) bid-ask spread. Currently we only have reliable data for end of day spreads, and do not directly observe the spread of bids and asks – although we are seeking access to this data. We would be concerned if bid-ask spreads persisted significantly above 5% over a period of weeks (as they did after the spring 2018 events)
- b) open interest, which reflects the total financial exposure to price variations in ASX contracts. Financial exposure to ASX prices is a proxy for confidence in the way that prices are established in the market. We would be concerned if open interest dropped significantly or ceased its upward trend (over a period of several months to a year)
- c) any effective withdrawal of one or more of the market makers, including by allowing performance of its market making obligations to deteriorate with no link to market fundamentals.

Another factor we would consider is the performance of the hedge market more broadly: the ASX arrangements are only part of the total suite of hedging options for managing spot price risk. We would particularly look at trading volumes across the range of hedging options, ie, the number of trades over a given time period. We would be concerned if trading volume dropped to zero for several days, or if it trended low over weeks and months.

On this point we note that trading volumes include off-screen trades, which can show a significantly different aggregate trading picture. For example we have included in Appendix A a record of aggregate on and off-screen volumes that reflects significant off-screen activity during the periods in which the spreads under the ASX arrangements had widened. We also include in Appendix A a graph of unmatched open interest.

Please feel free to share this letter with other interested parties.

Regards

R. Blundell.

PP

Rob Bernau
General Manager Market Design

cc: Al Yates, Ecotricity
 Luke Blincoe, Electric Kiwi
 Phill Anderson, Electric Kiwi
 David Goadby, Energyclubnz
 Steve O'Connor, Flick Electric
 Gary Holden, Pulse Energy
 Johnathan Eele, Vocus Group
 Robert Allen, Allen Consulting
 Grant Smith, Grant Smith Consulting Group

Appendix A ASX performance

Figure 1: ASX traded volume

Gigawatt hours traded by month and 6 month moving average

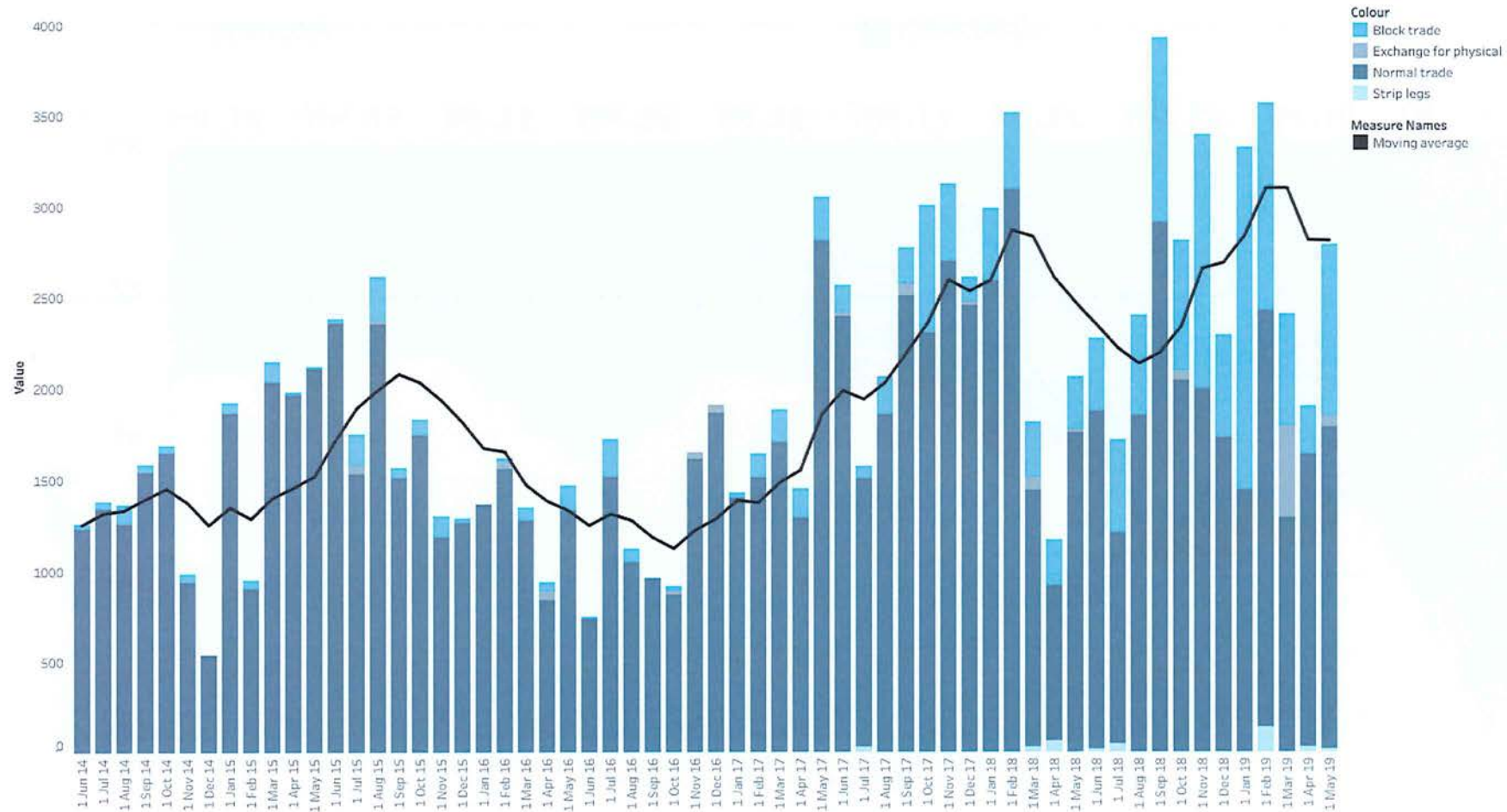


Figure 2: Unmatched open interest



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