23 July 2020

James Stevenson-Wallace
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By email: andy.doube@ea.govt.nz

Dear James

RE: Industry Forum thoughts on transition arrangements to an enduring incentivised market making scheme

Introduction

The members of the Industry Forum welcomed the discussion on 23 June 2020 with your Board on principles and high-level design elements of an incentivised market making scheme. The Board appeared positively disposed towards:

- the principles of beneficiaries paying for market making services;
- the design and terms of an incentive scheme informed by a competitive procurement process; and
- achieving a least cost arrangement through balancing the benefits and costs of different levels of service.

It was useful for the Forum members to receive first-hand Board member perspectives and questions, which included:

- who the beneficiaries of market making are;
- the cost and funding of an incentive scheme;
- the importance of the forward price curve reflecting generator-retailer views on price; and
- whether there was a potential for transition issues to arise.

At the conclusion of the discussion, the Chair invited the Industry Forum to provide ideas and approaches to transitioning that would maintain the integrity of the forward curve and mitigate the risk that the cost of the service "discovered" through the procurement process described was unaffordable.

The Forum members believe that:

- The integrity of the forward curve should remain robust through any transition.

- An appropriately designed two stage EOI/RFP process should allow the Authority to make decisions around the RFP terms and ultimate design of an incentivised scheme, to mitigate the risk that the process produces an unaffordable scheme.

Forward Curve Integrity

The forward curve for electricity prices has the characteristics of a public good:

- the price signals it contains are in the public domain (non-excludable), and
- the use of this information by one party does not impact its use by other parties (non-rivalrous).

Public goods have the potential to be underproduced relative to their optimal production level. In this case the transition to a new market making scheme should not compromise the integrity and value of the forward curve as a signal of future electricity prices, given their importance to investment and risk management decisions.

The effectiveness with which the forward curve will embody expectations of future electricity prices is typically maximised when:

1. There is a robust information disclosure regime – i.e. There are requirements on parties with information which has or could have a material impact on future supply and demand conditions (e.g. outage plans) to disclose that information publicly.
2. Participation is low cost – i.e. Reduced barriers and costs to transacting will reduce transaction costs and crowd-in participation, which again can be expected to improve the information content embodied in the forward curve.
3. A profit motive is maintained – i.e. Informed participants (including the generator-retailers) will have incentives to transact through the market when they observe future prices deviating materially from their expectations.

In addition, in the context of what the Forum members proposed, the prospect of a mandatory fallback scheme applying whether before or after the effective date of an incentivised scheme should also serve to ensure that the forward curve reflects generator-retailers' views on price.

Accordingly, the Forum members believe that the price disciplines imposed by these mechanisms should ensure the robustness of the forward curve and mitigate the need for any transition period or arrangement.

Compelling participation by informed market participants unnecessary and likely to result in sub-optimal outcomes

The Authority considers the confidence in the forward curve, as a signal for future prices, is enhanced with the active participation of "informed" market participants, such as the existing voluntary market makers. We agree, and for the reasons above, consider that this should occur.

We do not believe that it is necessary to compel an additional degree of market making by generator-retailers over a transition period or at all. As pointed out above, the generator-retailers will have an incentive to participate whenever they see prices deviate to some degree from their expectations. Moreover, we fully expect the generator-retailers to be well represented in the final selection of market makers based on the competitiveness of their bids alone. Any further requirement on generator-retailers participation is likely to

add complexity, entail costs that may exceed the benefits, and potentially result in a "two-tier" regime with unintended consequences. We also observe that if, following the RFP process, there are concerns of an absence of competitive pressure in the bids received, the Authority has the option to impose a mandatory scheme (potentially adapted as a consequence of the learnings from the RFP responses, including better information on market costs for services). This would serve as an additional incentive for generator-retailers to participate appropriately.

Given the Chair's invitation, however, the Forum members have considered how further assurance during the transition to a new regime might be provided through compelling (some) major generator-retailers to participate as market makers.

We have considered the option of incorporating some transitional arrangements (for up to 6 months) in which some generator-retailers are compelled to provide market making services in parallel to the least cost market makers that were successful in the RFP process. Due to the complexity of having market makers who were unsuccessful in the competitive process market making alongside those who were, this would be unwieldy, high-cost, and over procure market making services.

We also set out in **Appendix 1** two possible approaches if, despite our recommendations, the Authority is inclined to permanently require a certain number of generator-retailers to be included in an incentivised market making scheme. The Appendix also includes an example of how this might work in a two-step EOI/RFP process and some of the cost/participation trade-offs that would result. In respect of the example of what an EOI/RFP process might look like, while detailed, it hopefully illustrates some of the issues and questions that are likely to arise, and the importance of a well-designed EOI to the RFP stage and the ultimate market making scheme terms.

We do not endorse these examples but provide them in the spirit of contributing ideas which has characterised interactions between the Forum and the Authority to date.

Summary

The integrity of the forward curve should remain robust through the transition to a new market making scheme and a well-designed EOI/RFP process should mitigate the risk that the process produces an unaffordable scheme.

The Forum members appreciate the opportunity to contribute and trust these observations are useful to the Authority during its deliberations on the future market making scheme. The Forum members would be happy to meet with Authority staff or the Board to discuss these ideas further.

Yours sincerely,

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Contact		
Signatory	Matthew Cleland – General Manager, Wholesale Markets	
Signature		
Genesis		
Signatory	Warwick Williams - Senior Regulatory Counsel and Group Insurance Manager	
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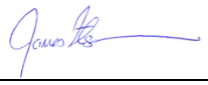
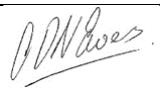
Mercury		
Signatory	James Flexman – Wholesale Markets Manager	
Signature		
Meridian		
Signatory	Chris Ewers – General Manager, Wholesale	
Signature		
Nova Todd		
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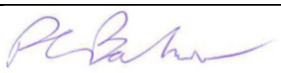
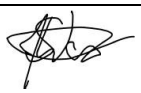
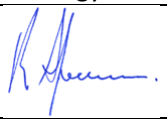
Signature		
Pioneer		
Signatory	Jonathan West – Chief Financial Officer	
Signature		
TrustPower		
Signatory	Richard Spearman - Energy Portfolio Manager, Strategy & Growth	
Signature		

Appendix 1: Possible approach

The required number of generator-retailer market makers, to provide the Authority with the assurances it requires in the forward curve's integrity, would be contracted to deliver market making services for the term of the scheme. To the extent that vertically integrated parties are selected for reasons other than being least cost, additional costs will be incurred.

At the end of the initial contract period, the Authority would review whether it has the confidence to relax minimum requirements on generator-retailers participation in future market making procurement rounds.

To determine the number and identity of the vertically integrated market makers, the Authority could either:

1. Specify the minimum number of VI market makers it requires to address any concerns with the curve's integrity. The least cost vertically integrated market makers would be chosen up to the minimum number required (e.g., if the requirement was for two generator-retailers in the scheme, then the two vertically integrated bidders with the lowest cost bids would be chosen). The remaining market making positions to be filled (over and above this minimum) would be selected from the remaining credible bidders based on their relative competitiveness, irrespective of whether they are vertically integrated or not.

2. Adopt a two-level evaluation process which gives the Authority the flexibility to choose the mix of generator-retailers and non-generator-retailer market makers, having regard for the bids received and the assessed delta in the level of integrity of the curve. The two-level evaluation process would involve:
    - first, an evaluation of the individual bids - all bidders are evaluated on the merits of their proposal and the short list of favoured suppliers is agreed
    - second, a portfolio evaluation – a selection is made from the short list to provide the Authority with the opportunity to select the mix of market makers which they believe best balances cost and transition risks. The cost of the scheme would be set by the marginal market maker, once the desired number of vertically integrated participants are included, regardless of whether they are a vertically integrated participant or not.

These two approaches are hybrid solutions, in that they rank credible bidders on the basis of the cost of their proposals, but they have the potential to depart from the least cost solution due to the Authority seeking (and willing to have beneficiaries pay for) greater assurance that the forward curve will better reflect vertically integrated enterprises' expectations. The merits of this approach are conditional on:

- the forward curve reflecting better information about future prices, because of the generator-retailer being a market maker and not just a market participant
- the forward curve reflecting better information about future prices, because of a generator-retailer being the marginal market maker, not a non-generator-retailers
- the net benefit justifies the (potential) additional cost.

See the flow chart (Appendix 2) and a stylised example (Appendix 3) of how these processes would work.

Prescribing minimum numbers of generator-retailer market makers

Additional costs for the provision of market making services will be incurred if the minimum number of generator-retailers chosen is greater than the number which would have been selected with sole regard for least cost provision. Therefore, prescribing a minimum number of generator-retailer market makers in advance of the Request for Proposal (RFP), and therefore absent bid information, creates the potential to prove expensive if a high cost generator-retailer is the marginal market maker.

However, it is reasonable to expect any competitive tender process, seeking four or more market makers, to receive at least two of the most competitive bids from the current market makers. This is due to a number of factors – there is likely only a limited number of credible new bidders attracted to this process; information asymmetry between incumbents and new entrants; and incumbents can be expected to bid aggressively where the choice is between getting paid to deliver a service or paying someone else more to deliver it. If the Authority believes that no more than two incumbents are required to address its concerns with the forward curve, then we perceive minimal cost and risk in specifying a minimum of two generator-retailers.

This risk is also offset further if the Authority were to increase the total number of market makers they are seeking to contract. For example, if the number of market makers in the scheme were to increase from four to five, then the Forum members believe specifying that at least two of the market makers, out of a total of five, would have to be generator-retailers, would have very low risk of a price escalation due to relatively costly bids from the generator-retailers.

One further advantage of setting a (low) minimum (e.g. so long as it leaves room for at least two non-generator-retailer market makers) might be to encourage bids from non-generator-retailer market makers because they can be more confident that if their bids are competitive then they will be accepted.

On the other hand, signalling a relatively high minimum number of generator-retailer market makers (relative to the number of generator-retailer market makers expected to bid) may detrimentally impact the bidding behaviours of these parties. Guaranteeing a minimum number of market making slots to generator-retailers reduces the competitive pressure within the group of generator-retailer bidders, and therefore the incentives to bid aggressively.

Two Step EOI/RFP Process Example

A decision between specifying a minimum and the two-level evaluation approach does not have to be made now. This decision can be made post the Expression of Interest (EOI) stage. Indeed, the EOI should be used as an opportunity to assess prospective bidders' appetite for these approaches, as well as what a reasonable minimum might be.

While the Forum members do not share the same degree of concern as the Authority might, we do believe there is a way to structure the market making procurement process so that the Authority has control over the extent to which generator-retailers are represented in the market making process (though with an associated cost).

To address the transition and cost risks identified above, an example of an approach that could be used is set out in the logic diagram attached. Key principles and points:

1. The Authority commits to the following principles across all future scenarios/solutions:
    a. Beneficiaries pay
    b. All market makers are paid the same for an equivalent service

    Where the contract for market-making services (e.g. number of market makers, spreads, volumes, penalties) are the same for both the incentivised and fallback schemes, accepting these two principles means that both these schemes are practically identical, but for two dimensions:

	Fallback/Mandatory Scheme	**Incentivised Scheme**
Identification of market makers	Market makers are identified by the Authority	Market Makers are selected via a competitive process (i.e. most competitive bidders subject to due diligence) For a *hybrid* scheme a mix of both mandated and competitive processes are used to identify market makers
Setting the size of the incentive pool to fund market making	The Authority would set the incentive pool, though it would rely in part on any cost information it uncovered through the EOI and/or the RFP process to inform this determination	The competitive bidding process dictates the size of the pool

2. A two stage (EOI/RFP) procurement process is followed, as per the Forum's original proposal, with the Authority reserving the right to revert to a fallback regime at any point during the procurement process.

    a. The two stage process we are proposing provides a robust means of defining the appropriate service contract having regard for cost/benefit trade-offs; de-risking participation by new entrants and fostering competition; transparently determining the market cost of any incentivised scheme; as well as providing additional information to inform the design of a more efficient fallback scheme.

3. The EOI is an opportunity to gauge interest from third parties in a competitive tender; gain a better understanding for major cost trade-offs for various levels of service; and inform the appropriate service contract for both an incentivised and fallback scheme

4. At the conclusion of the EOI stage, the service specification can be agreed.

    a. The identity and number of market makers under a Mandatory scheme should be revealed at this time
    b. If at the conclusion of the EOI stage the Authority determines that there is unlikely to be sufficient competition in the RFP stage, further exploration of the incentivised scheme would cease, and a Mandatory scheme finalised and deployed
    c. If the Authority elects to continue to explore the incentivised scheme, the Authority chooses between specifying a minimum number of generator-retailer market makers in the scheme, or a two-level (individual and portfolio) decision making approach and develops the RFP process to suit.

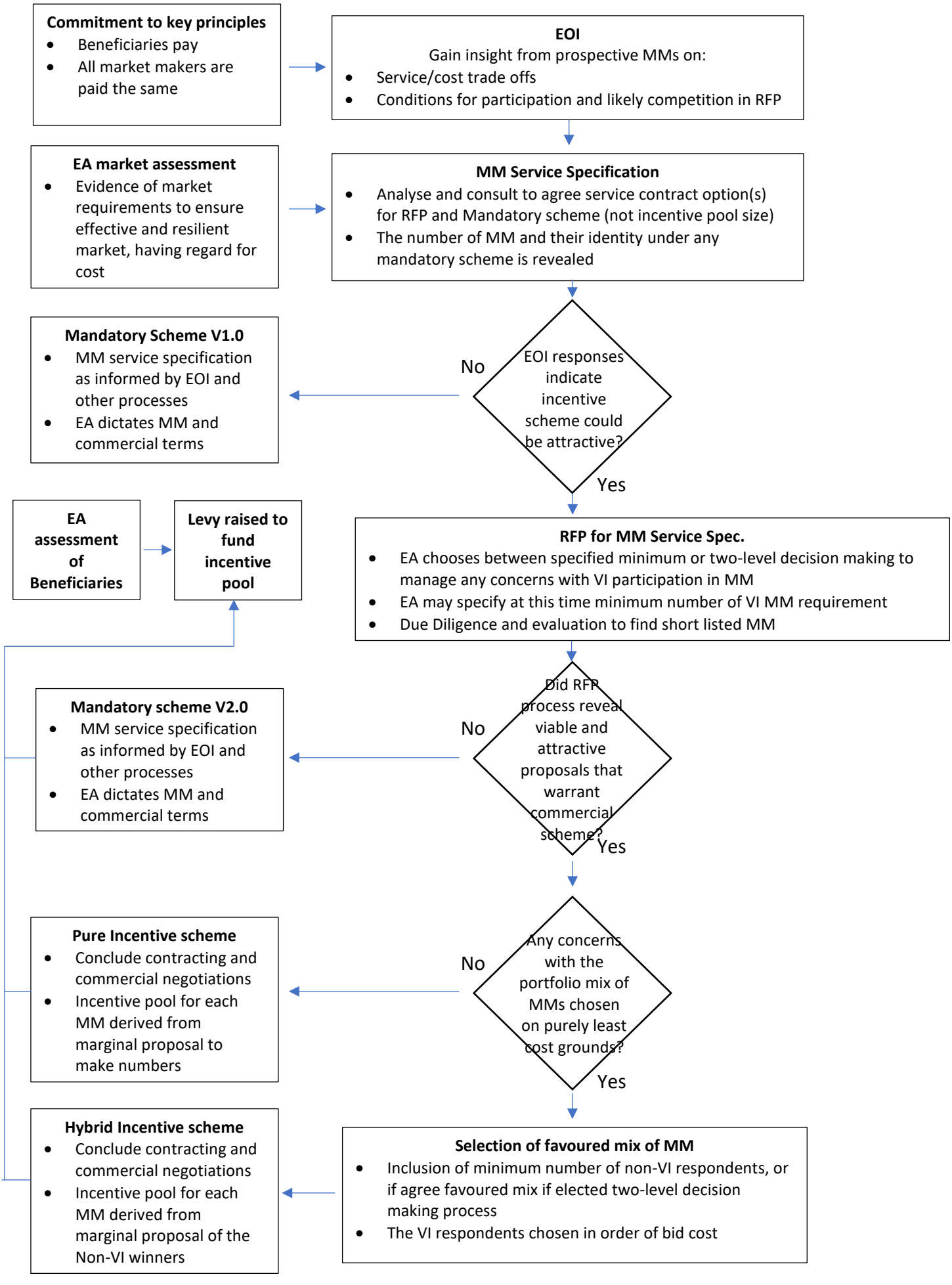
5. At the conclusion of the RFP process:

    a. The Authority should build into the process the scope to engage with each bidder to review the costings of their bids on an "open book" basis, and to engage in a commercial dialog to better understand the costing and provide scope for bids to be revised.
    b. If there are concerns about an absence of competitive pressure in the bids received, the Authority has the option to revert to a mandatory scheme, potentially adapted as a consequence of the learnings from the RFP responses (including better information on market costs for services).
    c. If the Authority is comfortable with the mix of marker makers selected on a minimum cost basis then this becomes the new group of market makers, and the incentive pool is determined by the least efficient successful bidder. A transition period might be required.
    d. If the Authority is uncomfortable with the mix of market makers selected on a minimum cost basis, because it is under-represented by generator-retailers, then generator-retailer marker makers are added and otherwise

successful non-generator-retailer bidders are removed, up until the point the Authority's concerns are satisfied. The cost of the least efficient generator-retailer bidder's proposal is used to determine the size of the incentive pool.

6. In all cases the Levy to fund the scheme, be it mandatory or incentivised, will need to be raised.

Flowchart of EOI/RFP process



Illustrative example of different mechanisms for managing representation from generator-retailers as market makers

Two broad approaches have been proposed for ensuring enough participation from vertically intetgrated (VI) entities in market making (MM). This issue only arises where the Authority has concerns that VI players would be under-represented in the portfolio of MM, to the extent it was concerned that the forward curve might not adequately represent VI specific market knowledge about future prices.

To see how the three options might work in pactice assume:

- the Authority is seeking 4 MM through its process.
- the following bids were received:

Bids from large domestic VI Operators	Bids from others
ABC $100 DEF $115 GHI $120 JKL $130 MNO $150	XYZ $100 UVW $105 RST $110

Incentive scheme - Least cost solution
If the bidders were selected on price alone the four winners would be ABC, XYZ, UVW and RST (being 1 VI participant and 3 non-VI participants) and the incentive pool would be $440 (RST is the marginal bidder and bid at $110, so the total pool would need to be 4 times that size).

We understand the Authority might have concerns with this outcome, given only one VI participant is a MM.

1. Minimum number of VI market makers is prescribed
If the Authority prescribes a minimum of 1 VI MM – then we get the same result (under these assumptions) as the least cost option, with a cost of $440.

If the Authority prescribes a minimum of two VI MM - The two least cost VI MMs are ABC and DEF. The two least cost non-VI MM are XYZ and UVW. DEF is the least efficient MM in this group so the incentive pool would be set at $460 (4 x $115).

If the minimum was set at three VI MM, then UVW would drop out and GHI would enter, and the new cost would be $480

2. Two staged evaluation

A variation of the prespcribed approach – rather than prescribing the minimum at the commencement of the RFP process, the procurement process provides a two stage evaluation:

- first, short listing of individual candidates on cost and due dilgence etc
- second, selecting from the short listed candidates the mix of MM that best meets the Authority's cost and other objectives (including transition concerns)

This approach has the advantage that the tradeoff between cost and the minimum number of VI market makers can be considered once bids have been received. It is likely to be attractive when there is significant uncertainty and variability in bids.

In the example above:

1 VI MM – cost $440
2 VI MM – cost $460
3 VI MM – cost $480
4 VI MM – cost $600

The Authority could utilise this information for example, to choose between 2 VI MM at a cost of $460 or just 1 at a cost of $440, having regard for any benefits from a greater number of VI MM.