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Hedge Market Enhancements – Permanent market making backstop

Genesis Energy Limited (**Genesis**) welcomes the opportunity to respond to the Electricity Authority's (**Authority**) consultation paper *Hedge Market Enhancements – Permanent market making backstop* dated 24 November 2020.

Resilience of market making arrangements

While there is always room for improvement, neither the New Zealand electricity futures market nor the current market making scheme is broken or failing. The scheme has evolved and improved over the past few years, with market makers, the ASX and the Authority showing that where necessary, they would work to ensure this.

This was demonstrated for instance in:

(a) December 2019, where market makers agreed to reduce bid-ask spreads from 5% to 3%.

(b) March 2020, where:

  (i) The ASX's pragmatic approach helped market makers address Covid-19 disruptions.

  (ii) The Authority supported the ASX's approach and where necessary, promptly clarified its expectations of market makers.

As the Authority noted:

(a) There were record levels of exchange traded futures during the March 2020 period, with no shortage of volume available.[1]

(b) The futures market and market making arrangements have proven resilient: in the face of potential market disruption risks arising from HVDC

[1] See: Letter from James Stevenson-Wallace to Ecotricity "Re: Urgent interim solution required for Spot and ASX markets" dated 1 July 2020 at: https://www.ea.govt.nz/development/work-programme/risk-management/hedge-market-development/correspondence/letter-from-ecotricity/

maintenance and gas supply outages; COVID-19; and uncertainty concerning the future of the Tiwai Point aluminium smelter.[2]

Evidence does not support proposed Code change

We agree that market making services are an important component of the New Zealand electricity futures market. They facilitate risk management, price discovery, and ultimately result in long term benefits for consumers.

Changes to market making, and the extent to which regulatory intervention should support these, must therefore be considered carefully. There should be a well defined problem with the status quo, with any changes supported by compelling evidence that:

(a) The changes will promote competition and benefit consumers.

(b) There is a material harm or risk with retaining the status quo.

This is why we advocated for, and supported the Authority's efforts in pursuing, an evidence-based approach to reviewing New Zealand's market making arrangements.[3]

In relation to the proposed Code change set out in the consultation paper:

(a) No evidence is presented that the futures market is "broken", that the liquidity of the futures market is materially threatened or that there is a material risk that market makers will cease providing services under their existing agreements with the ASX. There is also no evidence that the current voluntary arrangements are unable to evolve to meet the Authority's concerns as we transition to a longer-term commercial incentive based scheme. In fact, the evidence to date in both these respects has been to the contrary.

(b) There is no evidence that the temporary back stop scheme implemented in February 2020 (**Temporary Backstop**) improved wholesale electricity price discovery, liquidity or risk management, or resulted in economic benefits.[4] This is reflected in a number of respects in Sapere's cost benefits analysis report which accompanied the consultation paper. For instance:

(i) Sapere acknowledges that there is no data to allow a quantitative cost benefit analysis and stated:[5]

> *We are not convinced that fuel management, demand side operations, generation investment and demand side investment will*

[2] Paragraph 3.4 of the Consultation Paper.

[3] Genesis submission on *Hedge Market Enhancements – Market Making* dated 16 June 2020.

[4] The anticipated economic benefits of market making which supported the introduction of market making in New Zealand electricity futures are: improved retail competition, fuel management, demand side operations, generation investment and demand side investment.

[5] Sapere, *The benefits of introducing a backstop market making arrangement into the Code*, 9 October 2020, page 7.

be materially changed by the proposed permanent introduction of the backstop Code now. [6]

(ii) In explaining how they would assess the impact of the proposed change on retail prices, Sapere stated:[7]

> *Analytically, we would estimate the degree to which the energy component of retail prices is impacted by the narrower spread. We would attribute the reliability of the narrower spread that was reinforced by the introduction of the backstop market making provisions including the penalty regime. However, it is not possible to make that link statistically. No series of retail offerings is available other than the series we show in Figure 6, and the independent retailers have declined to offer any supporting evidence for such a link.*
>
> *We conclude that even though we are unable to quantify the benefits to consumers, the step to reinforce the tighter spreads and lower rate of withdrawal from market making through the mandatory backstop will have a positive impact on retail prices. Further, we are confident that any impact would be positive to the extent that independent retailers will either continue to compete on price as they do today or be bolder in their competitive offerings, armed with the confidence they get from the measure. It is reasonable to expect that the change to the voluntary scheme and the regulatory backstop will lead to retail prices (including those offered by vertically integrated firms due to competition) that would be lower than would otherwise be the case.*

With respect:

(aa) The truth of the matter is that the Temporary Backstop had no discernible impact on retail pricing, and the chart in Figure 7 of the Sapere report that attempts to show the reliability of a narrower spread over time, simply reflects that market makers have consistently complied with the terms of the applicable market making agreements – before and after the Temporary Backstop was implemented.

(bb) It is difficult to see how any reasonable conclusion can be reached on the impact of the proposed Code change on retail pricing or competition when, amongst other things: (i) independent retailers were unable to demonstrate how the proposal would change their pricing behaviour or how it would translate to long term benefits for consumers;[8] and (ii)

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[6] Ibid.

[7] Sapere, *The benefits of introducing a backstop market making arrangement into the Code*, 9 October 2020, page 15.

[8] Sapere, *The benefits of introducing a backstop market making arrangement into the Code*, 9 October 2020, page 9.

the expiry of the Temporary Backstop in November 2020 has not resulted in any identifiable adverse impact on retail pricing or competition.

(c) If the Authority considers that the forecast risk of a suspension or disruption to market making services is sufficiently high, the Authority can, as it did in February 2020, use its existing regulatory powers to promptly implement a Temporary Backstop. No evidence has been presented demonstrating that there is a material risk or harm with retaining the status quo, or that this approach could not or should not be used again.

(d) The Authority used section 40 of the Electricity Industry Act to implement the Temporary Backstop urgently and without consultation based on its perception of market disruption / failure risk at the time. Given the potential impact of this power, the legislature put an expiry period on Code changes implemented under section 40 recognising that a permanent intervention requires consultation and evidence to justify it. In this case, the Temporary Backstop was never used, there is no compelling evidence supporting a move to a permanent backstop scheme at this stage and, as discussed in paragraph (c) above, a backstop can be quickly implemented if required.

Conclusion

In summary, the past few years have tested New Zealand's market making framework and underlying arrangements. These have evolved and improved, with market makers, the ASX and the Authority acting where appropriate to ensure their resilience. No evidence has been presented to support a move to a mandatory backstop scheme at this stage and the Authority has the regulatory tools it needs to quickly implement a backstop scheme if one is required. Accordingly, we do not support the proposed Code change.

In our submission to the Electricity Price Review Panel on the issue of market making, Genesis:

(a) Agreed that the market making scheme in place at the time should evolve to ensure it is fit for purpose and durable for the future, especially during times of volatility and market stress.

(b) Advocated for the implementation of an incentive-based scheme as soon as practicable, with the appropriate regulatory safeguards.

We reiterate those views and for the reasons set out in previous submissions and discussions with the Authority, consider that that an incentive based scheme (with a mandatory scheme as a back-up) which has been developed through a competitive market feedback and price discovery process should result in a scheme that is flexible, resilient, cost effective, with service levels appropriate for the New Zealand context. In short, a market making scheme that is, and remains, fit for purpose, and which delivers long term benefits for consumers.

Consultation on the appropriate mandatory backstop market making scheme is best included in the market feedback / price discovery process for the voluntary incentive scheme. This ensures a holistic approach and minimises the risk of unintended consequences from putting in place a permanent backstop ahead of the feedback / competitive process.

Please don't hesitate to contact me (warwick.williams@genesisenergy.co.nz) should you wish to discuss any of the matters in this submission further.

Yours sincerely

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