SUBMISSION:

Hedge Market Enhancements – Permanent Market Making Backstop

18 January 2021

EXECUTIVE SUMMARY

The Electricity Authority ('the Authority') operates under the statutory objective to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.

In its Hedge Market Enhancements – Permanent Market Making Backstop Consultation Paper ('the Consultation Paper') the Authority sets out that its first step and highest priority in implementing its decision on an enduring approach to market making is to amend the Electricity Industry Participation Code (2010) ('the Code') to address the expiration of the temporary regulatory backstop to its voluntary market making scheme. It states this will benefit consumers because the mandatory backstop enhances market maker performance in the electricity futures market, which allows:

a) New Zealand electricity market participants to benefit from a robust and liquid forward price curve; and

b) Those that trade in the ASX futures market to benefit from liquidity and price efficiency supported by market making; and

c) Greater competition in the retail and generation markets.

emhTrade Markets is fully supportive of the objectives set out in the Consultation Paper, and acknowledges the need to address the requirement for a regulatory backstop, but is concerned the Consultation Paper:

1. Has not contemplated the impact of the recommended approach on the prospective tender for commercial market making services, which will result in a lack of clarity inevitably increasing the costs of the tender process and may reduce the efficacy of the outcome; and

2. Fails to address the structural flaws which characterised the temporary regulatory backstop, significantly limiting the backstop's ability to deliver the benefits sought as set out above; and

3. Fails to address the need for the Code to stipulate the maximum allowable exemptions which parties may negotiate in their Market Making Agreements and does not require those Agreements to be published.

RESPONSE TO THE CONSULTATION PAPER'S THREE QUESTIONS:

1. Do you have any feedback on the Authority's cost-benefit analysis set out in Appendix A?

The cost-benefit analysis is sound as regards the material it does cover; however, it has limitations in that:

1.1 It erroneously records Volume refresh ("reload") as "not recently", whereas for most of the period from 2011-2018 it was an obligation.

1.2 It focuses on introducing a backstop market making arrangement into the Code without explicitly considering the context – namely that for the Authority this is the "first step and highest priority in implementing its decision on an enduring approach to market making".

In doing so it has failed to consider the cost/benefits and increased/decreased costs associated with market making services and the future procurement of commercial providers.

1.3 It does not consider any alternatives to its recommendation that the expired emergency backstop effectively be reinstated 'as is' via Code amendment.

1.4 It does not consider the negative consequences of the Code not stipulating the maximum number of exemptions that parties may negotiate in their Market Making Agreements, nor the implications of such material information not being transparently available to the market.

2. Do you have any feedback on the Regulatory statement in Appendix B?

The Consultation Paper which has informed the Regulatory Statement conflates the wider hedge market / market making strategy with this particular Code change, particularly with regards to the alternatives that have been considered. The paper talks of alternatives to the wider strategy and why they have been discounted but is silent on alternatives to this Code change as part of that strategy.

It therefore doesn't appear that the Authority has satisfactorily considered alternatives as the Regulatory statement sets out.

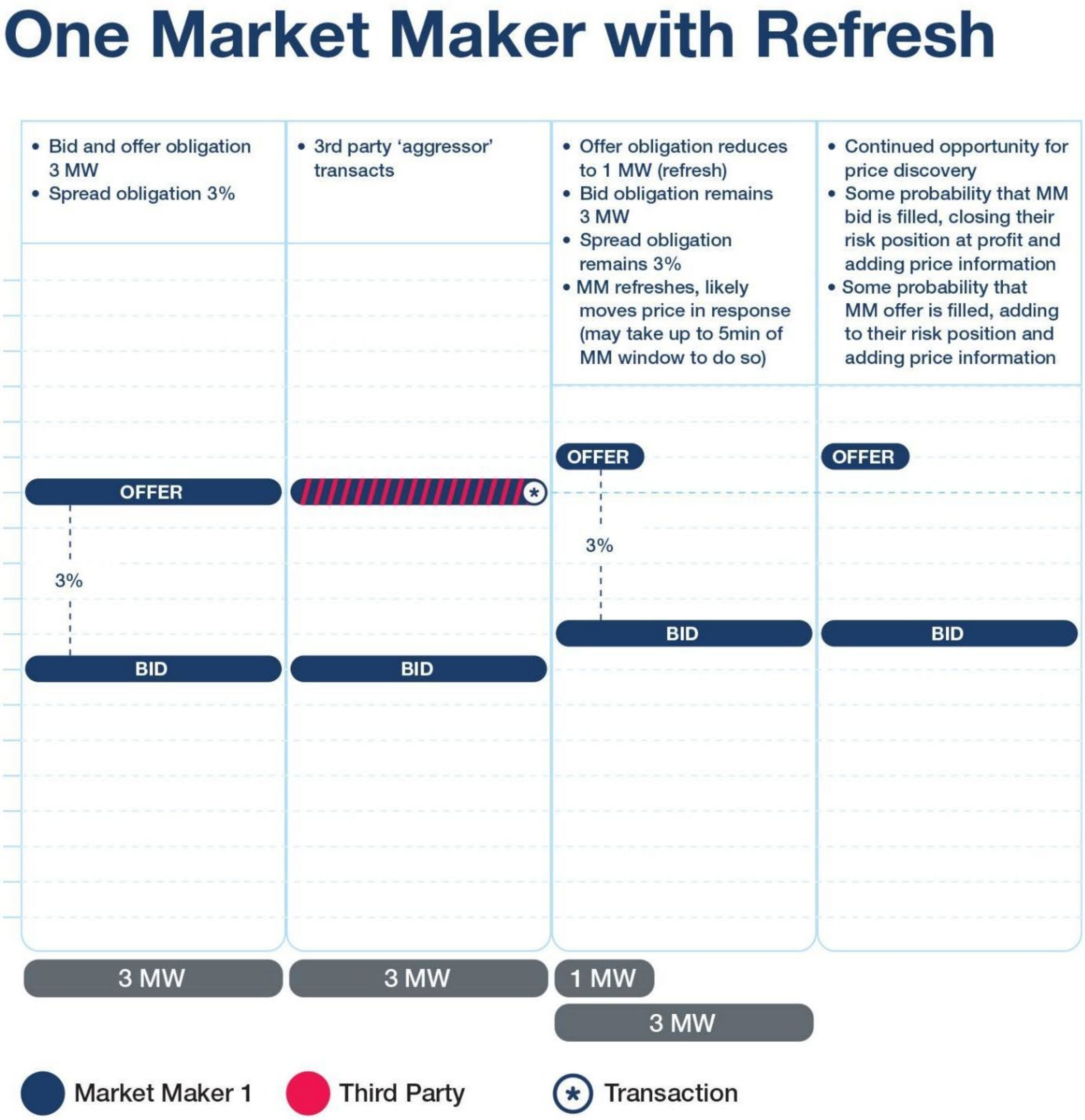
3. Do you have any feedback on the Code amendment set out in Appendix C?

3.1 The amendment should have a refresh obligation – either as pre-2019 which included the obligation for a participant to quote 3MW with a refresh of 1MW; or with a lower initial volume (with the total volume remaining the same).

The impact of having a refresh and that of not having a refresh are best illustrated in the following diagrams, however first please note:

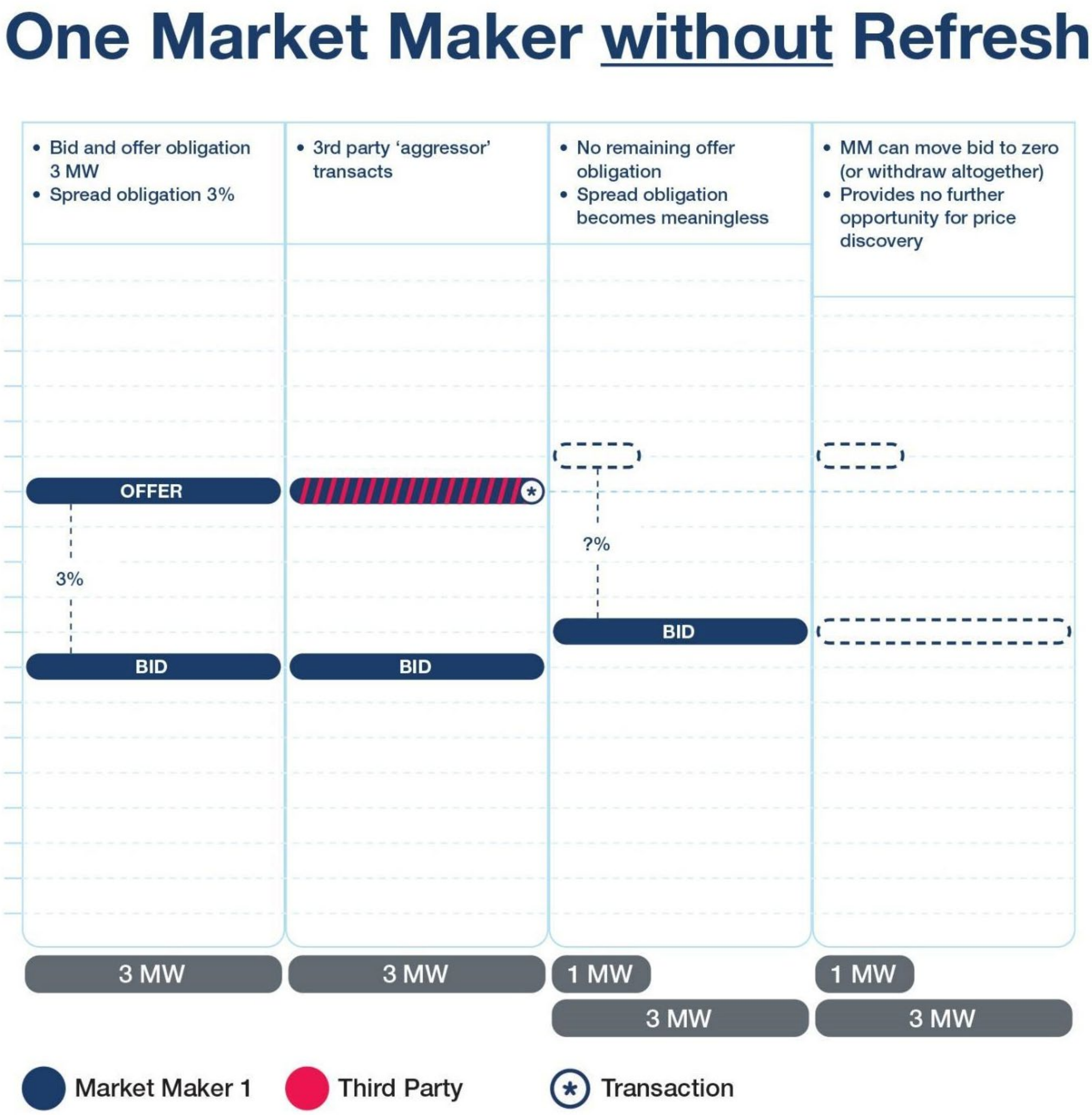
- Removing the refresh often more than halves the available liquidity – even though at face value it appears to be only 25% of the total volume obligation; and
- Maintaining the obligation to quote the side that hasn't been transacted ought to be very low cost to market makers as their propensity to trade this side should increase following a transaction on the other side.

The reasons for this can best be illustrated as follows. The obligation for a participant to quote 3MW with a refresh of 1MW will lead to **materially lower costs for market makers, greater liquidity overall,** and **lower costs to consumers.**

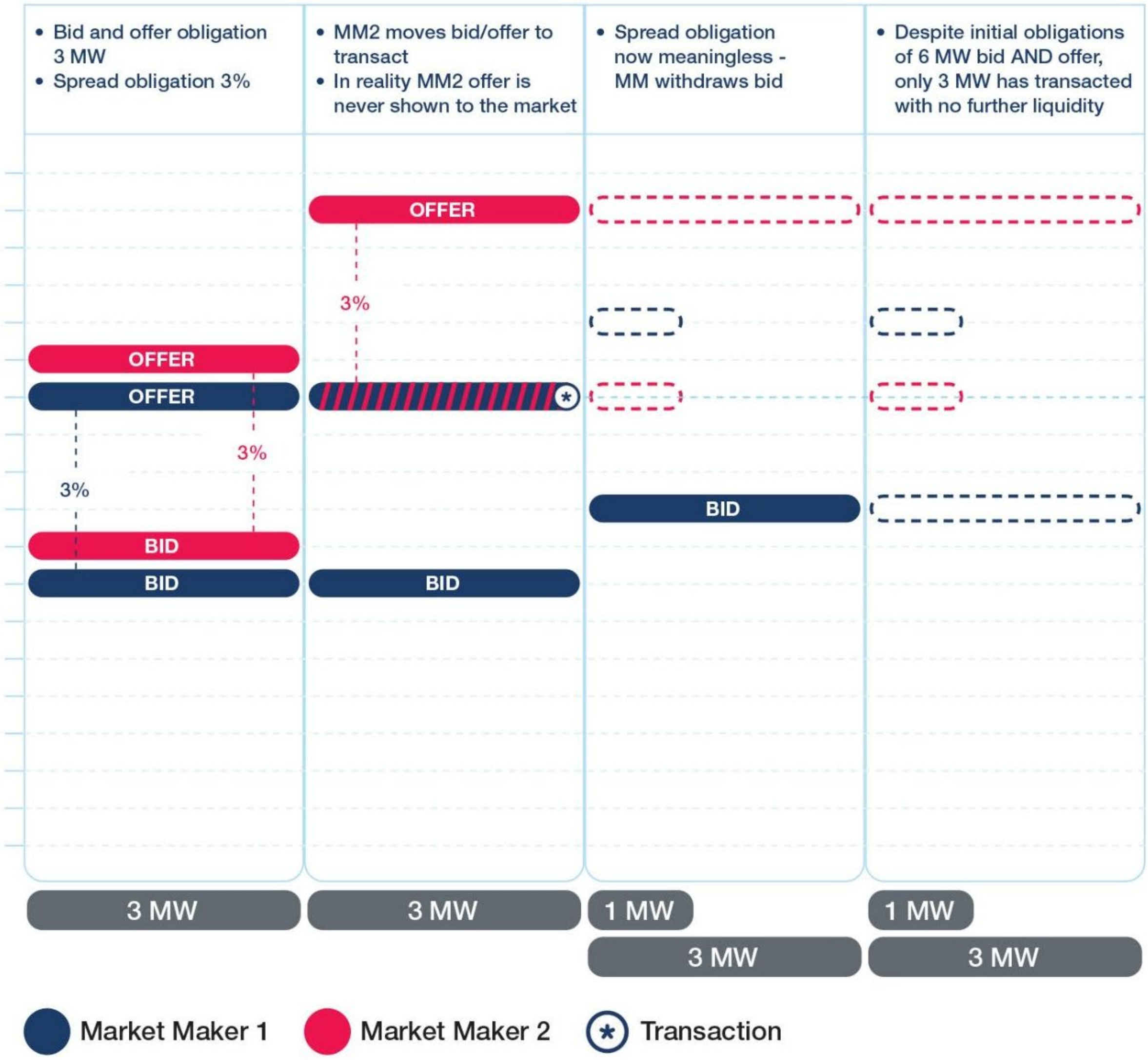


Removal of the refresh obligation has a non-linear, negative impact on total liquidity.

Without even a small refresh there is **massive loss of volume** and **no further price discovery**.



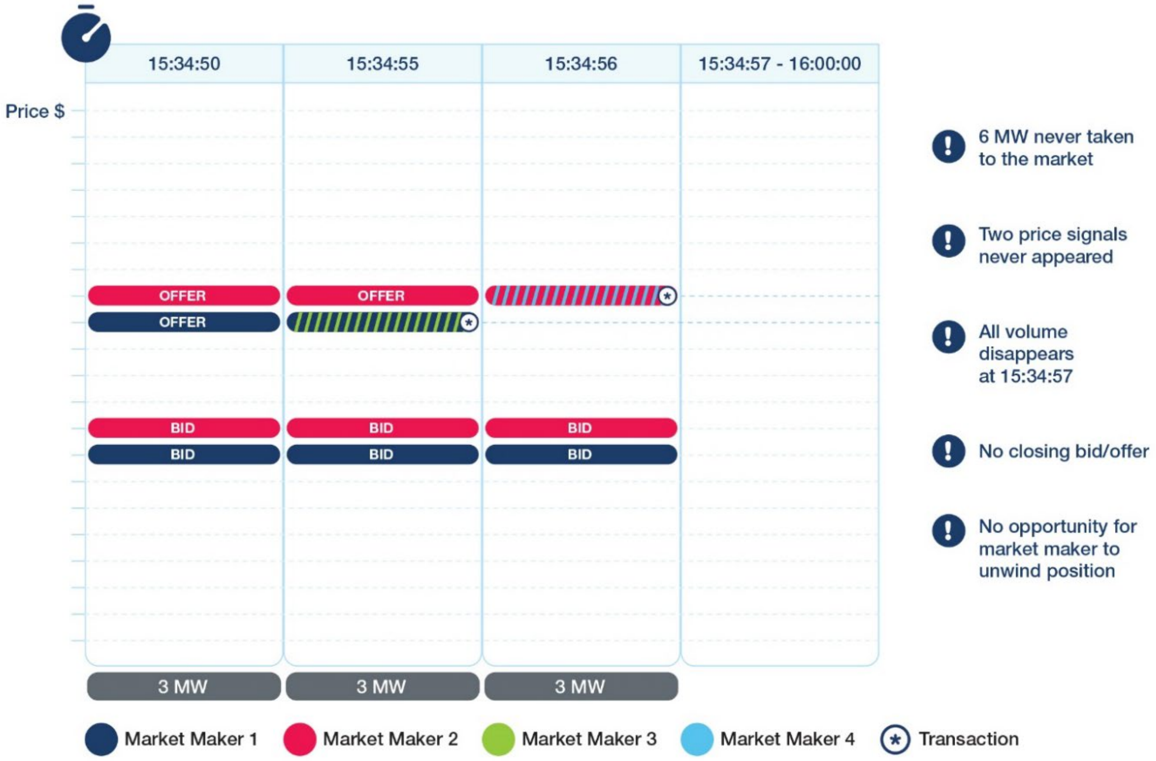
Without Refresh and Aggressor is also a Market Maker



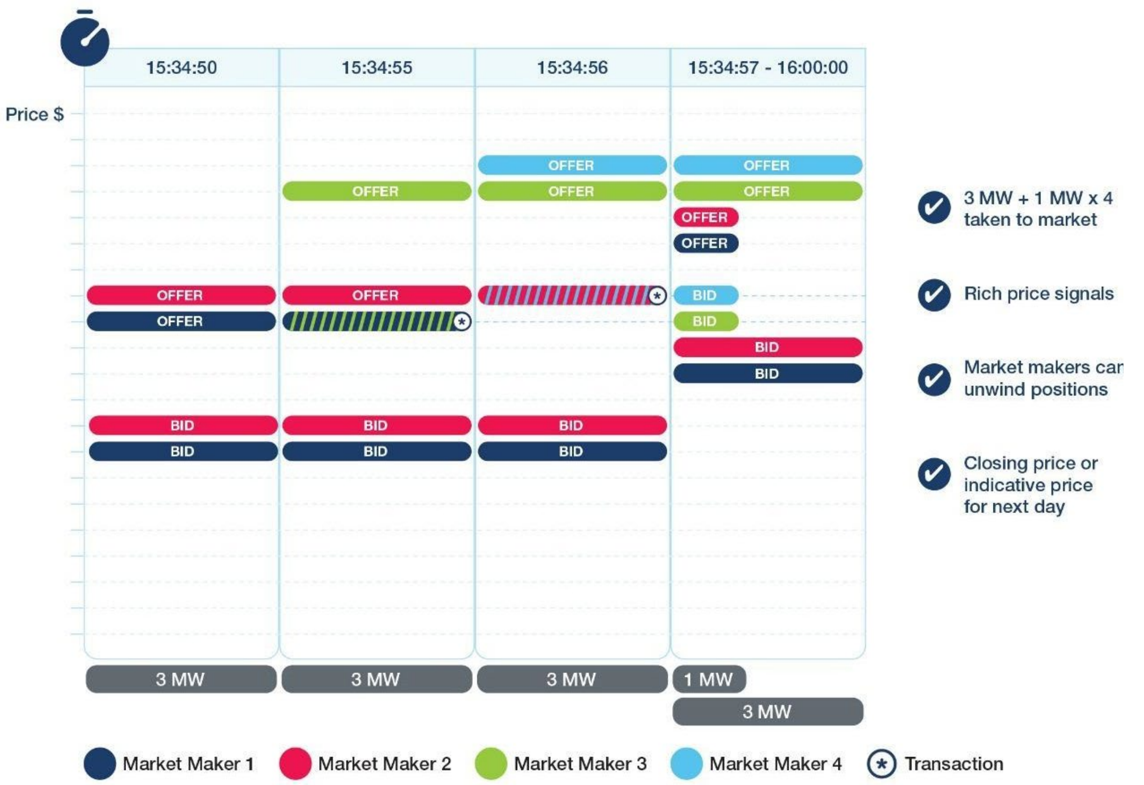
The voluntary arrangements in place (with a refresh) still carried an obligation to show the non-traded side of a two-way quote. As can be observed through comparison of tick data, a lack of refresh means this obligation (and the liquidity it provided) has been lost. This liquidity is larger in magnitude than the refresh itself, but generally very low cost since it is offsetting previously transacted volume[1].

[1] This is because the propensity of a party to buy(sell) should increase(decrease) if their offer(bid) is transacted, since doing so will reduce their net risk position for the day.

Observed Behaviour – Current Obligations



Observed Behaviour – Refresh Obligation



As can be seen, without addressing the requirement for a refresh, a mandatory backstop will fail to deliver those things the Authority sets out in the Consultation Paper, namely:

a) New Zealand electricity market participants benefit from a robust and liquid forward price curve; and

b) Those that trade in the ASX futures market benefit from liquidity and price efficiency supported by market making; and

c) Greater competition in the retail and generation markets.

Finally, the granular price discovery established through a refresh is important because it leads to:

- **Confidence in the closing price** - for participants as well as for the ASX, which has to manage the risk this has produced by charging higher initial margins (increasing the cost of market making and hedging); and
- **Confidence as to what fair market price is.** When there are no quotes at the end of the day, participants have no confidence that the settlement price (last traded price if no quotes) bears resemblance to where the fair market price is. This results in price and margin discontinuities from one trading period to the next, ultimately increasing the cost of market participation with the ensuing impact on participants; and
- **Within-day liquidity for market makers to unwind some of their unwanted positions.** This is likely to dramatically lower the cost of market making.

3.2 The wording around exemptions lacks certainty and transparency and should be clarified.

Under the proposed clause 13.236K (2)(c) market makers are free to negotiate any number of exemptions without publishing them, so there is a risk of information failure because of information asymmetry in the market, creating an unquantifiable risk for potential commercial market makers.

3.3 Overall, the signal that these Code changes aren't final (with the Authority planning to run a tender process in parallel to procure more market making services) creates additional uncertainty. The Authority must provide more information on how and when the changes might be refined because this, and any subsequent Code changes, will have a direct impact on the cost of the provision of those services.

Without certainty around these areas, suppliers to the subsequent procurement process will have to build the costs associated with the uncertainty around these structural issues into their pricing models.

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APPENDIX A

The following charts show ASX NZ Pricing on Market Close over 2020.