22 June 2021

Submissions
Electricity Authority

By email: WholesaleConsultation@ea.govt.nz

Levy consultation: Commercial Market-Making Scheme

Meridian appreciates the opportunity to provide feedback to the Electricity Authority on the consultation paper *Levy consultation: Commercial Market-Making Scheme*.

The consultation paper indicates the significant value of the market-making service currently provided by Meridian and three other market-makers (up to $72 million per annum based on the Authority's numbers). That service is delivered at zero expense to other ASX market participants and beneficiaries of the market-making service with all costs borne by the four market-makers.

Meridian considers that all market-makers should be compensated for providing the service and that compensation should be funded by the beneficiaries of the ASX New Zealand Electricity Futures market. Meridian would like to see the Authority move towards a fully commercialised market-making scheme as soon as possible. Having only one of five market-makers paid for providing the same service reveals the entirely arbitrary nature of the current arrangements.

There is value in increasing the number of market-makers beyond the existing pool but this should only ever be considered a transitional arrangement to prove the concept of commercial market-making from a range of service providers that compete through a regular tender to provide the desired service level at least cost.

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Meridian's responses to the Authority's specific consultation questions are included in Appendix A.

In addition, while Meridian understands that the "Market operations" activity in the Electricity Industry (Levy of Industry Participants) Regulations 2010 is a convenient way of allocating the costs of market-making, we do not consider that allocating the costs of market-making under this activity would amount to a beneficiaries-pay approach. Electricity industry participants and beneficiaries of the ASX New Zealand Electricity Futures market do not perfectly overlap, for example:

- Parties, such as a large industrial purchaser, that have locked themselves into long-dated bilateral contracts extending well beyond the traded window of the ASX are not likely to consider themselves beneficiaries of the ASX New Zealand Electricity Futures market.
- The ASX New Zealand Electricity Futures market is not limited to physical participants and several parties speculate in futures and derive significant benefit from this activity and the market-making that supports it. Speculation would not occur if that were not true. However, these parties will not contribute anything to the costs of market-making under the Authority's levy proposal, meaning speculators will continue to extract revenue from market-makers, physical participants that pay the levy, and ultimately consumers.

Meridian encourages the Authority to engage with ASX on options to partially fund the costs of market-making via ASX transaction fees. Fees could be set at a level that provides a meaningful contribution to costs without overly disincentivising ASX transactions.

Please contact me if you have any queries regarding this submission.

Yours sincerely

Sam Fleming
Manager Regulatory and Government Relations

Appendix A: Responses to consultation questions

	Question	Response
1.	What is your view on the Authority's proposed 2021/22 commercial market-making appropriation amount of $14.4m?	The proposed appropriation of $14.4 million is more than Meridian was expecting. It appears to be explained by the administration component of the appropriation, the undisclosed contingency component, and the fact noted by the Authority that the median indictive price from existing market-makers was approximately $3.6 million per annum lower than the indicative price from potential new suppliers (hence the need to ask question 5 below). More competitive indicative pricing from existing market-makers would confirm that existing market-makers are providing a cost-effective market-making service and the most efficient approach may be to procure the same mix of market-makers but on a commercial basis to ensure: • the service is right-sized; • beneficiaries of the public good pay for it; • free rider problems are avoided; and • market-making costs are no longer arbitrarily imposed on only four firms. It is worth noting that if 20 percent of the value of the market-making service currently provided is indicatively $14.4 million per annum, this suggests that the current market-makers are providing a service worth up to $72 million per annum at zero expense to other ASX market participants and beneficiaries of the market-making service. The mandatory market-making backstop does not promote competition or efficiency. Rather, it is an entirely arbitrary imposition on the current market-makers based on nothing more than the size of their balance sheets. The arbitrary allocation of costs tilts competition in favour of non-market-makers. The sizing of the market-making service is also arbitrary as the Authority has not established that 12MW is an efficient level of market-making. All maker-makers should be compensated for the service they provide, and that compensation should be funded by the beneficiaries of the ASX New Zealand Electricity Futures market. Meridian would like to see the Authority move towards a fully commercialised market-making scheme as soon as possible.

2.	What is your preferred volume of market-making services in MW per contract? Please provide quantitative and qualitative reasoning.	Given the nature of existing market-making arrangements the Authority is unlikely to receive objective responses to this question. For example, as an existing market-maker subject to the mandatory backstop and associated costs, Meridian supports a lesser volume of market-making service to reduce the costs that have been arbitrarily imposed upon it. Conversely, as long as non-market-makers are exposed to less than their share of market-making costs (i.e. only 20 percent initially) they will be overly incentivised to seek higher levels of service. This is particularly the case where a non-market-maker is able to extract financial benefit from market-making through speculative activity. Given the incentives created by a hybrid mandatory and commercial scheme, a more objective way to approach this question would be for the Authority to examine the ASX data that it has been collecting from industry participants. Meridian suspects that the data will show market-making services are over supplied and that a significant portion of the trades that occur between a market-maker and a counterparty are speculation rather than the hedging arrangements of physical market participants. Given the levels of unmatched open interest in the market, there is certainly no justification for total market-making volumes in excess of the current 12MW total. Contracts are consistently available to those that want to purchase.
3.	What is your preferred level of bid-ask spread – 2% 3%, 4% or 5%? Please provide quantitative and qualitative reasoning.	Meridian prefers a wider minimum bid-ask spread because spreads are a legitimate signal of the level of uncertainty regarding future spot prices and wider spreads enable market-makers to better manage the cost of providing the service. Again, as long as non-market-makers are exposed to less than their share of market-making costs (i.e. only 20 percent initially) they will continue to be overly incentivised to seek tighter bid ask spreads. This is particularly the case where a non-market-maker is able to extract financial benefit from market-making through speculative activity.
4.	What is your preferred combination of volume and spread? Please indicate in the table provided your top five preferences, where 1 is most preferred	Assuming spreads would be the same for all market-makers and any reduction in total market-making volumes would be evenly spread across all market-makers (through a parallel change to the voluntary market-making agreements with ASX as well as a change to the Code for the mandatory backstop),

	combination and 5 is least preferred.	then Meridian would prefer lower volumes and higher spreads. How much volumes could decrease before physical participants might struggle to build positions is unclear. The Authority will have greater insights given the data available to it. However, Meridian's expectation is that physical participants would have no problem building positions to hedge their risk if total market-making volumes were 8MW or 10 MW rather than 12MW in total. Therefore, Meridian's preferences are: • 1.6MW and 5% spread • 1.6MW and 4% spread • 1.6MW and 3% spread • 2MW and 5% spread • 2MW and 4% spread. We hope that greater appreciation of the costs of market-making might make a reduction in the level of market-making services viable. Meridian would not want the Authority to retain the current service levels (2.4MW per market-maker and 12MW total with spreads of 3 percent) simply because that is what parties have accepted to date. Given the levels of unmatched open interest in the market, there is certainly no justification for total market-making volumes in excess of the current 12MW total. Contracts are consistently available to those that want to purchase.
5.	What value do you see in increasing the number of market-makers beyond the existing pool of regulated market-makers? Please provide quantitative and qualitative reasoning.	For Meridian, as an existing market-maker there is value in increasing the number of market-makers beyond the existing pool if this helps to prove the concept of commercial market-making from a range of different service providers that compete through a regular tender to provide the desired service level at least cost. However, Meridian does not consider this to be a necessary criterion for a successful commercial market-making scheme. Meridian does not think it would be a problem for the existing market-makers to be commercialised and continue to deliver the service. This may be the most cost-effective option.

		We are interested in responses from other participants and the reasons why a more expensive service from other providers might be preferable. Meridian would like to see the Authority move towards a fully commercialised market-making scheme as soon as possible. We disagree with the Authority that a cautious partial step is necessary – to deliver only 20 percent of the service on a commercial basis. The resulting hybrid model will be overly complex and reveals the extent to which the mandatory component of market-making is arbitrary. The existing market-makers have an ongoing incentive to participate in any tender process to provide the service as they are all significant levy payers and have a financial interest in minimising the cost of providing the market-making service. The only way for an existing market-maker to minimise the costs of commercial market-making is to compete to provide an efficient service. Meridian does not think there is a risk of non-participation by existing market-makers nor do we think there is any risk to the durability of the forward curve in the event a fully commercialised scheme is adopted. However, to the extent the Authority is concerned and sees a need to test a wider pool of market-makers, Meridian will not be opposed so long as costs are not significantly and unreasonably higher than the tenders from exiting market-makers.