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Hedge market improvements are vital for the health and development of competition

Electric Kiwi, Flick Electric, Haast Energy Trading (Haast), Pulse and Vocus (the independents) welcome the Electricity Authority's consultation on proposed Code amendments for market-making arrangements.

We reiterate "Hedge market arrangements are a significant determinant of the extent and health of competition in the electricity market, and the size of barriers to competition from new entrant and independent retailers. This is particularly evident with current market circumstances. Addressing the problems with the hedge market is necessary for the Authority to achieve its statutory objective to promote competition, and its strategic ambition of "thriving competition".[1]

We also reiterate, "We agree with the Authority … that "Consumers benefit from market-making activity" to the extent "it allows retailers to offer consumers deals on their electricity, helping to protect them from volatile spot prices" and "new retailers to manage their price risk". A well-functioning hedge market can "[allow] smaller and less diversified businesses without generation or a retail presence to manage their price risk, which reduces barriers to entry, helping to increase competition in both the generation and retail markets"".[2]

Our views on the importance of hedging arrangements are supported by the work MDAG is doing on the transition to 100% renewables. MDAG has emphasised the need for contracting (hedge arrangements) to do the "heavy lifting" and that "it is important that the types of products needed to manage risk in a 100%RE will be available to market participants". We similarly agree with Contact's submission: "the hedge market will be a crucial part of a 100% renewable electricity system".

Summary of the independents' views

- We agree with the Authority about the importance "that liquidity in products of all time durations enables all participants to trade with confidence".[3]

[1] Ecotricity, Electric Kiwi, Flick Electric, Haast Energy Trading (Haast), Pulse, and Vocus, The independents support levy-funding for supply of commercial market-making by new suppliers only, 21 June 2021: https://www.ea.govt.nz/assets/dms-assets/28/Haast-+-Independent-Retailers-submission-Levy-Consultation-Commercial-Market-Making-Scheme.pdf
[2] Ecotricity, Electric Kiwi, Flick Electric, Haast Energy Trading (Haast), Pulse, and Vocus, The independents support levy-funding for supply of commercial market-making by new suppliers only, 21 June 2021.
[3] Electricity Authority, Energy transition roadmap, 9 December 2021.

- **Hedge market development shouldn't be conducted in a silo.** The appalling results from the Authority's UMR survey and the MDAG work on the transition to 100% renewables highlights the importance of hedge market reform if competition is going to thrive and develop.

- The Authority's comment that there is "a lack of confidence by some stakeholders in market-making and the market for exchange traded contracts" [emphasis added] should be seen in the light of the UMR survey finding that only 19% of market participants consider that independent retailers are operating on a level playing field (18% in relation to independent generators) and "21% agreed hedge market, including ASX and OTC reflect the outcomes expected in a workably competitive market". This consists of only 12% of market participants if gentailers are excluded, and only 8% of independent retailers.

  It would appear that "some stakeholders" includes most market participants other than vertically-integrated suppliers i.e. everyone that isn't a member of ERANZ.

- **The problem is a vertical-integration issue:**[4] We agree with the Authority that "... integrated generator-retailers' controlling the bulk of electricity generation can raise competition concerns" and "Confidence in the industry, and the regulation of the industry by the Authority, may be undermined by dominant vertically integrated generator-retailers behaving strategically to increase the costs of rivals, thereby limiting competition and increasing their own profitability."[5]

- The European Union has observed "One of the main obstacles to the development of a true level playing field for access seekers ... is the preferential treatment of the downstream businesses, for example the retail arm, of a vertically integrated operator with significant market power (SMP operator) through price and non-price discrimination ..."[6] The EPR reached similar conclusions e.g. "Vertical integration has costs and benefits ... it can hinder competition because independent generators and retailers will find it hard to compete if vertically integrated companies refuse to deal with them or do so only on unfavourable terms".[7]

- **Consideration should be given to introduction of new services:** We note the Authority's prior statement that "The Independent Retailers raised concerns that incumbent market-makers have limited incentives or interest to offer, for example, day-time peak products" and response that "As the Authority implements its decision there will be opportunities for all participants to provide feedback and influence the level of market-making services provided to the market".

- **We reiterate our preference remains that mandatory market-making arrangements be introduced.**

- **The current 12MW total regulated market-making requirement should be retained, and commercial market-making used to increase volume**.

- **Phase-in of commercial market-making arrangements:** We note the statement "The first stage of the approach regulated will likely see 20% of the total market-making obligation provided by one or more commercial providers, with the remaining 80% provided by the four market

[4] Refer, for example, to Ecotricity, Electric Kiwi, Flick Electric, Pulse and Vocus, The independent retailers support introduction of mandatory market-making, 18 January 2021; in particular, the section "ACCC and EPR investigations provide strong support for the Authority proposals", at: https://www.ea.govt.nz/assets/dms-assets/27/Independent-retailers-Hedge-Market-Enhancements-Permanent-mandatory-market-making-backstop-submission.pdf.

[5] Electricity Authority, Internal transfer prices and segmented profitability reporting, Consultation paper, 8 April 2021.

[6] Article 14(3) of Directive 2002/21/EC: https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32002L0021

[7] Electricity Price Review, FIRST REPORT FOR DISCUSSION, 30 August 2018 at https://www.mbie.govt.nz/dmsdocument/4334-electricity-price-review-first-report-technical-paper.

makers" [emphasis added]. Consideration should be given, particularly if bid prices are high, to whether the regulated market-makers should each supply a greater MW share of market-making than the commercial market-maker(s).

- **Regulated market-making requirements should be in proportion to size of generation:** The Authority could also consider whether a more competitively neutral regulated market-making arrangement would be for Contact, Genesis, Mercury, and Meridian's shares of the 12MW regulated market-making requirements to be in proportion to their generation (or generation capacity).

- **Spreads could be narrower:** The benefits from lowering spreads from 5% to 3% are clear. The Authority should consider the additional benefits to wholesale markets that could accrue if this is narrowed further.[8]

- **We support rolling exemption days, but with less exemptions:** We suggest this be reduced to 2 days per 20 trading days.

- **We support provision for monthly trading 12 months out rather than just the current 6 months.** This would enable market participants to better trim their hedge book before hydrology, etc increases risks.

- **Penalties for non-compliance should be increased:** The mandatory backstop should be triggered immediately when the voluntary scheme fails. Clause 13.236K should be amended by replacing "on three or more occasions in a period of 90 days" with "on any occasion" or equivalent.

- In addition, the threshold for "allowing market makers to return to the voluntary market after a period of good performance" should be extended from 90 days to 365 days of compliance.

- **Commercial market-making could provide net benefits if it results in diversity of supply:** The changes we support (see above) do not depend on introduction of commercial market-making. We would support these changes if the Authority retained the current back-stop market-making arrangements only. As per our last submission on this topic, commercial market-making will only result in net benefits if it increases the number of market-makers.

- **Exacerbator-pays is more efficient than the Authority's proposed cost socialisation:** It is efficient for the existing regulated market-makers to bear the cost of market-making arrangements. The Authority's comment that "Allocating the cost of market-making to all generators and all purchasers [i.e. cost socialisation] will be a more efficient outcome" indicates a preference for cost socialisation over the current exacerbator pays arrangements. The Authority position is inconsistent with the views the Authority has expressed about cost socialisation in transmission pricing.

Hedge market development shouldn't be conducted in a silo

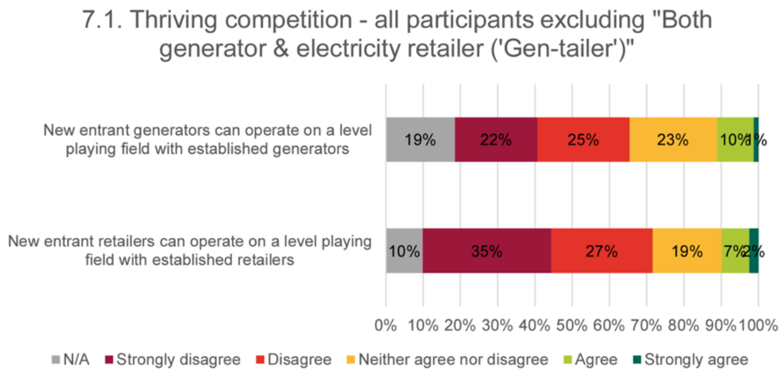
The results of the Authority's UMR survey and the MDAG work on the transition of the wholesale electricity market to 100% renewables are both directly relevant to the Authority's progression of changes to market-making arrangements.

[8] Insufficient information was provided in the last consultation for us to provide a definitive view on the cost of this change and whether it is justified.

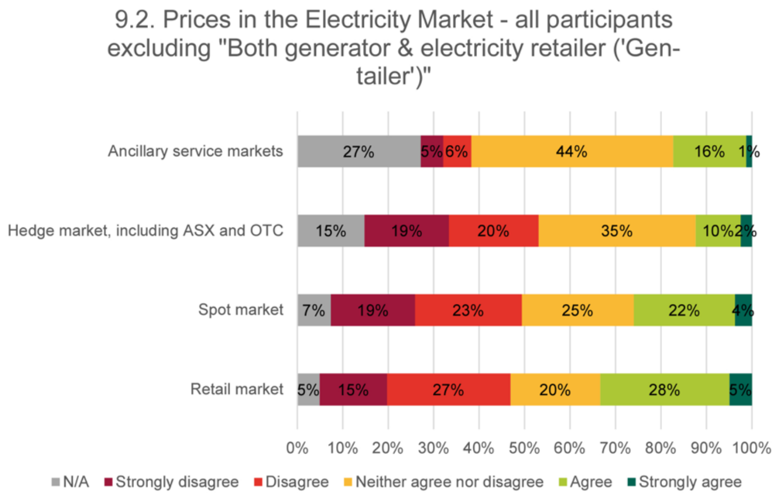
The Authority's comment that there is "a lack of confidence by some stakeholders in market-making and the market for exchange traded contracts" [emphasis added] should be seen in the light of the UMR survey finding, for example, that:

- "19% [of market participants] agreed new entrant retailers can operate on a level playing field with established retailers." This consists of only 9% of market participants if gentailers are excluded, and 0% of independent retailers.[9]

- "18% agreed new entrant generators can operate on a level playing field with established generators." This consists of only 11% of market participants if gentailers are excluded.



- "21% agreed hedge market, including ASX and OTC reflect the outcomes expected in a workably competitive market." This consists of only 12% of market participants if gentailers are excluded, and only 8% of independent retailers.



The MDAG 100% renewables project is particularly relevant to the hedge market development project "goal of ensuring market-making services are sustainable and fit-for-purpose". The work MDAG has done so far highlights that hedge market arrangements will become increasingly important for retail competition and the efficient operation of the electricity market, and hedge market arrangements will need to adapt and evolve to ensure they deliver the services required to manage risk. The MDAG work also highlights the risk that vertical-integration will increasingly become the preferred default if robust hedge market arrangements are not in place e.g.:

- "Contracts market will have to do more 'heavy lifting'".

[9] Electricity Authority response to Official Information Act request, untitled, 15 March 2022.

- "Questions arise as to whether the required range of products, information and liquidity will emerge in a timely manner."

- "… increased volatility per se should not pose unmanageable risks for investors or purchasers provided they can enter into suitable forward contracts. This involves both access to the products themselves and having confidence in the pricing of those contracts."

- "Given the importance of the contract market to providing incentives for generation, and allowing retailers to efficiently manage risk, … it will be [and is] critical to ensure the availability of risk management products that participants require, as the transition to a higher volatility market takes place."

- "… it is important that the types of products needed to manage risk in a 100%RE will be available to market participants."

- "Sapere ultimately conclude that the increased transaction costs associated with market contracting in a more volatile world increase the likelihood that vertical integration will be preferred more as a risk management solution."

The proposed service levels should be enhanced

The independents have the following views on the proposed service levels for both regulated market-makers and commercial market-makers:

- **[Q2] Volume should be larger:** At a minimum, the Authority should leave the existing obligations at 3 MW for the existing market-makers and bring in 3 MW of commercial market-making for 15 MW total. The trading data used to support the refresh rule shows the market has appetite for significantly more volume.

  We note that "Mercury considers market making obligations could reasonably be scaled back for additional market makers. While the level of bid/offer spreads would need to be consistent the volumes required to be offered could be less (e.g. incumbent market makers required to offer 3MW with newer market makers offering 1MW)".[10]

- **[Q3] Spreads could be narrower:** The benefits from lowering spreads from 5% to 3% are clear. The increased volume and open interest are a direct result of this. Gentailers have increasingly spoken to the benefits of the ASX market as an alternative channel for them in their investor briefings. The Authority should consider the additional benefits to wholesale markets that could accrue if the spread is narrowed further.

- **[Q4] We support rolling exemption days, but with less exemptions:** We support the change but the Authority should also reduce the number of exemptions available. Being able to be absent 25% of the time is far too generous and diminishes the scheme significantly. We suggest the exemptions by reduced to 2 days per 20 trading days.

- **We support provision for monthly trading 12 months out rather than just the current 6 months.** This would enable market participants to better trim their hedge book before hydrology, etc increases risks.

[10] Electricity Authority, Permanent market making backstop, Decision Paper, 30 March 2021.

- **Penalties for non-compliance should be increased:** We are concerned the mandatory backstop is only triggered after 3 or more occasions of non-performance in 90 days, combined with the provision allowing market-makers to return to voluntary market arrangements after 90 days of compliance, encourages non-compliance or 'playing to the referee'.

  The mandatory backstop should be triggered immediately when the voluntary scheme fails. Clause 13.236K should be amended by replacing "on three or more occasions in a period of 90 days" with "on any occasion" or equivalent. Having two lives diminishes the importance of the scheme in addressing imbalances in access to wholesale markets between integrated and non-integrated participants.

  In addition, the threshold for "allowing market makers to return to the voluntary market after a period of good performance"[11] (clause 12.236k(3)(a)) should be extended from 90 days to 365 days of compliance.

Consideration should be given to potential introduction of new services

We agree with the Authority questions whether market participants "have the tools and capability they require to manage financial risks in a world of increased volatility?" and "Do more risk management products need to be introduced into the market – from cap products to standardised power purchase agreements?"[12]

We reiterate our suggestion that "the Authority consider the types of hedge market products/risk management tools that should be required to be available, particularly before the Authority attempts to procure incentive-based market-making services. This is something that can and should evolve over time. A challenge independent retailers have is limited availability of products other than base-load. The incumbent market-makers have limited incentives or interest to offer, for example, day-time peak products. We would be happy to individually discuss with the Authority the experiences we have had".[13]

In response the Authority previously stated: "The service levels of market making were out of scope of this consultation. As the Authority implements its decision there will be opportunities for all participants to provide feedback and influence the level of market making services provided to the market".[14]

[11] Electricity Authority, Permanent market making backstop, Decision Paper, 30 March 2021.
[12] Electricity Authority, Energy transition roadmap, 9 December 2021.
[13] Ecotricity, Electric Kiwi, Flick Electric, Pulse and Vocus, The independent retailers support introduction of mandatory market-making, 18 January 2021 at: https://www.ea.govt.nz/assets/dms-assets/27/Independent-retailers-Hedge-Market-Enhancements-Permanent-mandatory-market-making-backstop-submission.pdf.
[14] Electricity Authority, Permanent market making backstop, Decision Paper, 30 March 2021.

[Q7] There could be net benefits from increasing diversity of supply

We reiterate "The principal benefit from commercial market-making is increase in diversity of supplier":[15]

> The Authority has noted:
>
> > "Potentially an increased diversity of market-makers with different views will help to create a more robust understanding of future prices"
> >
> > "The addition of commercial market-making service providers should strengthen and support the operation of the hedge market. Introducing commercial market-making providers should help improve the reliability and efficiency of the hedge market, while offering the opportunity to increase the diversity of participants."
> >
> > "Accessing a wider pool of market-makers will introduce more information to the forward price curve, as well as potentially introducing more efficient providers of market-making services, contributing to greater reliability and greater confidence in the forward price curve."
>
> Similarly, the Authority was also clear in its decision to introduce commercial market-making that "Introducing a commercial market maker would add further value to those who currently benefit from market making services" and "increas[e] the diversity of participants":

Increasing the diversity of market makers was mentioned by submitters, including Fonterra, the independent retailers and the industry forum. Trustpower saw increasing diversity as less important.	The Authority considers there are several benefits to increasing the diversity of market makers, including increased trust and confidence in market outcomes, and improved robustness of the forward price curve. Opening service provision to a diverse group of providers will also facilitate innovation and more efficient providers of market making services.

> If the Authority selected one of the existing incumbent, mandatory market-market making suppliers it would not result in the diversity benefits for determining the forward-looking price path the Authority anticipated when making its decision on market-making.

The changes we support (see above) do not depend on introduction of commercial market-making. We would support these changes if the Authority retained the current back-stop market-making arrangements only. As per our last submission on this topic, commercial market-making will only result in net benefits if it increases the number of market-makers.

If the outcome of commercial market-making was simply that one of the incumbent suppliers provides both mandatory and commercial market-making services we don't consider there would be any incremental benefits.

Exacerbator-pays is more efficient than the Authority's proposed cost socialisation

It is efficient for the existing regulated market-makers to bear the cost of market-making arrangements. This is consistent with exacerbator or causer pays. The need for regulated market-making arrangements exists because the access providers have significant market power, are vertically-integrated, rather than not stand-alone generators, and the services are needed for independent suppliers (access seekers) to be able to compete.

The Authority's comment that "Allocating the cost of market-making to all generators and all purchasers will be a more efficient outcome" is inconsistent with the views the Authority has consistently expressed in relation to cost socialisation in transmission pricing over the last decade.

[15] Ecotricity, Electric Kiwi, Flick Electric, Haast Energy Trading (Haast), Pulse, and Vocus, The independents support levy-funding for supply of commercial market-making by new suppliers only, 21 June 2021.

We reiterate that the existing arrangements where Contact, Genesis, Mercury, and Meridian bear the costs of market-making services "is efficient and consistent with "exacerbator pays", and the decision-making frameworks the Authority has applied to various pricing issues".[16]

The Authority has applied its decision-making and economic framework for both distribution and transmission pricing and the framework which clearly ranks exacerbator-pays above beneficiaries-pay and over "administrative" approaches such as the proposed cost socialisation approach. The Authority's pricing principles for distribution pricing are based on exacerbator pays.[17]

Concluding remarks

We reiterate we only support the increase in levy if it is to fund a new commercial provider,[18] or if the Authority considers it necessary in order to increase the volume above 12 MW.

We consider that the Code changes to the existing market-making arrangements, should increase the volume of market-making and potentially also should reduce spreads below 3%. The Authority should also tighten the exemption provisions to reduce the extent to which the incumbent suppliers can game the regime.

Yours sincerely,

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[16] Ecotricity, Electric Kiwi, Flick Electric, Haast Energy Trading (Haast), Pulse, and Vocus, The independents support levy-funding for supply of commercial market-making by new suppliers only, 21 June 2021.
[17] Notably, the Authority's decision paper, More efficient distribution network pricing principles and practice, 4 June 2019, doesn't even make any reference to beneficiary-pays.
[18] Ecotricity, Electric Kiwi, Flick Electric, Haast Energy Trading (Haast), Pulse, and Vocus, The independents support levy-funding for supply of commercial market-making by new suppliers only, 21 June 2021.