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2 December 2019

Submissions
Electricity Authority
2 Hunter Street
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By email to: HME.feedback@ea.govt.nz

To Whom It May Concern,

Discussion Paper – Hedge Market Enhancements

1. This letter sets out Vector's submission on the Electricity Authority's (the Authority's) discussion paper on Hedge Market Enhancements (the Discussion Paper). Our key points are summarised below and discussed in more detail in the body of the submission.

Summary

- We are pleased to see the Authority taking a renewed interest in the hedge market. In our view, insufficient attention has been given to this important issue, and to the performance of the wholesale electricity market in general.

- New Zealand suffers from very low liquidity in the hedge market and a high level of vertical integration. This makes risk management difficult for independent generators and retailers, which in turn raises barriers to entry and weakens competition in both the wholesale and retail markets.

- The current voluntary market making arrangements, which have been in place since 2011, have proved insufficient to address the above concerns. The Authority should move directly to implementing mandatory market making obligations (MMMOs) on the five large vertically-integrated gentailers, rather than undertaking an extended consultation process. The issues around hedge market performance and market making have already been extensively canvassed, including as part of the Electricity Price Review (EPR).

- While there are always risks of unintended consequences with any new regulation, we consider that the potential downsides of imposing MMMOs are low relative to the benefits. The estimated financial costs of market making referred to in the discussion paper are insignificant relative to the cashflows of the large gentailers, and market making activity can also be profitable. Furthermore, the costs of market making could fall rather than rise under a mandatory scheme.

- Implementing mandatory MMOs is the minimum that should be done to improve the performance of the electricity wholesale market. Further work is needed, most importantly to address ongoing concerns over the exploitation of wholesale market power, which evidence suggests is costing customers hundreds of millions of dollars every year.

The hedge market is performing poorly

2. Evidence from a variety of sources clearly shows that New Zealand suffers from low liquidity in the hedge market and a high level of vertical integration. Cumulus Asset Management (the majority-owner of Electric Kiwi and a fund that participates in many deregulated wholesale electricity markets around the world) has noted that *"New Zealand stands out to us as having among the lowest levels of wholesale liquidity relative to its size, and one of the highest levels of vertical integration"*.[1]

3. Analysis from CEPA, commissioned by Vector for its submission on the first EPR report, found that contract churn rates (the volume of contracts traded relative to physical volumes) in the New Zealand wholesale market are well below those observed in comparable markets such as Australia and the UK, while buy-sell spreads are materially higher.

4. While there is no 'consensus' level for a churn ratio that indicates a satisfactory level of market liquidity, commentators in other jurisdictions have suggested that a desirable level lies above three. Figure 1 below shows that contract churn rates in New Zealand are approximately half this amount.

5. With respect to bid-offer spreads, we note that as well as average spreads that are consistently higher than in other comparable markets[2], there have been significant 'spikes' in spreads at times of system stress. Most recently this has occurred in October 2018 and March 2019 when spreads rose as high as 50%, according to the EPR.

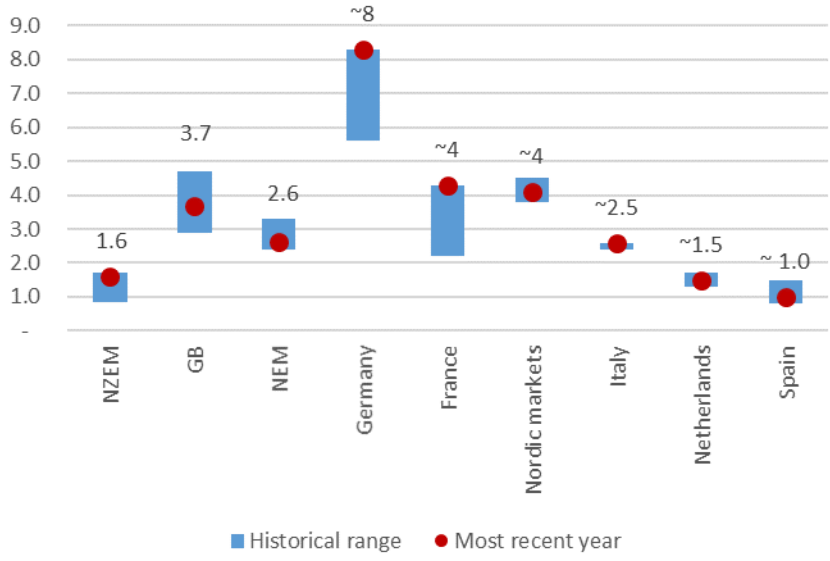
6. A poorly performing hedge market makes risk management difficult for independent generators and retailers, which in turn raises barriers to entry and weakens competition in both the wholesale and retail markets. The relationship between vertical integration and contract market liquidity can become a vicious circle – vertical integration reduces incentives to trade, which reduces contract availability and liquidity, in turn reinforcing the trend to vertical integration.

7. Although the Discussion Paper acknowledges some of these concerns, overall we consider that it downplays the extent of the problem. The EPR noted in its final report that market making in the contract market is currently *"fragile and unpredictable"* and that *"we think it vital to correct this fragility [in the contract market] to protect the competitive process".*

[1] https://www.ea.govt.nz/dmsdocument/19666

[2] As discussed in p7 of CEPA's report for Vector, the Secure and Promote licence conditions in the GB electricity market targeted spreads between 0.5% and 1.0%. However even prior to the introduction of these regulations in 2014, spreads were well below those observed in the NZ market.

Figure 1 – Contract Churn Rates, NZ vs Other Jurisdictions



Voluntary market making arrangements are not working effectively

8. The current voluntary market making arrangements between the four largest gentailers and the ASX, which have in place since 2011, have proved insufficient to address the above concerns. The hedge market continues to perform poorly compared to relevant benchmarks. Furthermore, as the Discussion Paper acknowledges, the voluntary arrangements are fragile – market makers have the ability to withdraw from providing services at times of 'portfolio stress', but the criteria used to identify such periods are opaque to other market participants (including other market makers).[3] Market makers have at times also suggested that they could withdraw from market making services entirely. This undermines confidence, which is crucial for a well-performing market. It may also create a 'contagion' effect whereby the withdrawal of one market maker increases the risk and costs on other participants, leading them to withdraw in turn.

9. As noted in the Discussion Paper, market making services have features of a public good – for example, they support a robust forward price curve, which is of benefit to all market participants. They also support hedge market liquidity, which is particularly important for smaller independent players. It is therefore not surprising that market making services will be under-supplied in the absence of regulation, and that market participants may seek to 'free

[3] We note that the voluntary arrangements have recently been modified to allow market makers to withdraw services five times per month at a time of their choosing, rather than based on a 'portfolio stress' indicator. Whether this will improve market functioning remains to be seen.

ride' on others. Voluntary undertakings are unlikely to be sufficient to ensure socially optimal outcomes in such an environment.

Mandatory market making arrangements should be implemented without delay

10. In Vector's view, the Authority should move directly to implementing mandatory market making obligations (MMMOs) on the five large vertically-integrated gentailers, rather than undertaking an extended consultation process to consider alternative approaches. As highlighted in paragraph 4.5 of the Discussion Paper, the issues around hedge market performance and market making have already been extensively canvassed by both the Authority (including the Authority's Wholesale Advisory Group), and the EPR Panel. The problems with the existing arrangements are well-known, and it is not clear to us that an additional period of data-gathering and analysis is needed.

11. While there is always scope for unintended consequences with any new regulation, in our view the potential downsides of imposing MMMOs are low relative to the benefits. In particular:

    - The estimated financial costs of market making referred to in the Discussion Paper are insignificant relative to the cashflows of the large gentailers[4], and market making activity can also be profitable, as the paper notes in the case of Contact in 2017. The Discussion Paper does not present compelling evidence to support its view that "market making appears to be a material cost to market makers on average".

    - The costs of market making could potentially decline under mandatory arrangements rather than rise, because: (i) market makers would be likely to invest more resources in improving their performance if the service is compulsory, and (ii) the potential for the contagion effect described above would be avoided.

    - We consider it is very unlikely that vertically-integrated gentailers would restructure their entire businesses to avoid MMMOs, given the low costs involved relative to the benefits of vertical integration, which appear to be high in the New Zealand market. The Discussion Paper notes that Ofgem is currently proposing to suspend MMMOs in the UK following restructuring of many of the companies that were originally subject to the regulations. However, our understanding is that these restructurings were driven by a variety of factors and not undertaken primarily to avoid MMMOs. The UK market has always had somewhat lower levels of vertical integration than New Zealand, and

[4] Operating expenditure for the five large gentailers totalled $9.3bn in 2018/19, while EBITDA totalled $2.4bn and operating cashflow $1.8bn. Even if market making were to cost each gentailer $2mn on average (i.e. $10mn in total), this would amount to just 0.1% of annual opex, 0.4% of EBITDA, and 0.5% of cashflow. In reality the costs are likely to be less than this – e.g. we note that NERA's report for the Australian Energy Market Commission (AEMC) estimated costs of MMMOs at between $17mn and $19mn for the entire National Electricity Market (NEM), which is more than four times the size of the New Zealand market.

vertical integration has declined further in recent years following restructuring – potentially mitigating the need for continued MMMOs in the UK.[5]

- MMMOs provide greater certainty to all market participants that the market making arrangements are stable, which increases confidence in the market and may in turn promote more trading activity by other players.

- Finally, compliance and monitoring costs are unlikely to be materially higher under a mandatory scheme, given that the Authority already monitors hedge market performance under the existing voluntary arrangements (and would also need to do this under an incentivised scheme). Indeed, monitoring activity could become more straightforward and less costly following imposition of MMMOs, since the requirements on parties would be clear and transparent – in contrast to the current situation, where the criteria for participation and withdrawal are opaque to both the regulator and other market participants.

12. On the other hand, we consider that the Authority may be underestimating the costs and risks associated with developing an incentivised market making scheme. Most importantly, an incentivised scheme is likely to take considerably more time to design and implement than a mandatory scheme. Recent events in the wholesale market (e.g. the 'spikes' in bid-ask spreads in October 2018 and April 2019, along with the significant trend upward in forward prices) have already led to the exit of several independent retailers. It is imperative that steps are taken to improve hedge market performance as soon as possible, before the next period of heightened market volatility occurs.

13. To implement an incentivised scheme, the Authority would need to consult and decide on the size of the incentive and how the costs of it should be allocated, which will almost certainly lead to material disputes among parties. As the Discussion Paper notes, the prospect of a subsidy or incentive payment will create incentives for market makers to overstate the costs of market making (and/or understate the benefits) in order to increase the payment they receive. A procurement process would also be required if the Authority decides to contract with service providers directly on a commercial basis. Implementing an incentivised scheme could take a year or more – far too long given the issues evident in the wholesale market. By contrast, MMMOs could be implemented almost immediately under urgent Code amendments.

14. It should be kept in mind that implementing MMMOs is not a 'once and for all' decision. The Authority can (and should) build in a post-implementation review of the arrangements, perhaps after two years, as it is currently proposing for the Saves and Win-backs Code amendments.

[5] According to Ofgem's website, the six largest energy retailers now account for 72% of the retail market but only 52% of the generation market. Centrica/British Gas and E.On have now sold the bulk of their large fossil fuel generation plant, while SSE recently announced that it will be divesting its household retail portfolio to Ovo, an independent retailer.

Alternatively, the Authority could put its interim MMMOs in place and then undertake a full consultation on enduring arrangements, which could include both mandatory and incentivised options, combined with a tender process for an incentivised scheme. Based on the outcome, it could then decide whether to retain or replace the interim MMMOs.

Further action is needed to improve wholesale market functioning

15. Implementing MMMOs would be a positive step forward, and one that we believe is long overdue. However, enhanced market making alone will be insufficient to address the serious and long-running concerns over wholesale market performance.

16. As we noted in our response to the EPR, a particular concern is the ongoing evidence of significant market power in the wholesale market. Recent modelling analysis by Dr Steve Poletti at the University of Auckland (part-funded by Vector and peer reviewed by Professor Derek Bunn at London Business School) estimated that wholesale market power rents in the period 2010-2016 amounted to $5.4 billion. This equates to over $350 per customer per year.[6] These figures are of a similar order of magnitude to those estimated by Frank Wolak in his 2009 report for the Commerce Commission – despite using a different methodology which accounts for all the substantive criticisms of the Wolak report. We are disappointed that the Authority appears to have dismissed the evidence presented in the Poletti report.[7]

17. New Zealand has a very 'light touch' regime compared to most other jurisdictions with respect to monitoring and mitigating market power. In our view, the current 'Undesirable Trading Situation' (UTS) provisions in the Electricity Industry Participation Code are only a weak deterrent, and even in cases where breaches have occurred the penalties have been minimal. At a minimum, the Authority needs to step up its enforcement activity under the existing provisions as well as consult on options for strengthening the UTS regulations.

Concluding remarks

18. We welcome the renewed attention on hedge market performance and market making, in line with the EPR recommendations. However, we consider that more urgency is needed in tackling the issue. The Authority's approach to date has been unduly cautious, which has favoured incumbent generator-retailers over smaller independent players.

[6] Based on EA figures for total ICPs as at 30/09/2018.

[7] An article on Stuff.co.nz on 14 September 2018 (the same date the Poletti report was released), stated that Rory Blundell, acting chief executive of the Electricity Authority, was unconvinced by the report. He was quoted as saying that "This kind of analysis has been found wanting in the past and we believe will again."

19. Implementing a mandatory market making scheme is only a first step in improving the performance of the wholesale market. The Authority should also give urgent attention to other issues, most importantly the ongoing concerns over exploitation of market power.

Yours sincerely

Richard Sharp
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