Hedge Market Enhancements

Permanent market making backstop

Decision Paper

30 March 2021

Executive summary

In August 2020, the Authority decided to pursue a long-term vision for market making that enhanced the market making arrangements at the time while improving efficiency, increasing trust and confidence in the market, and facilitating a service-oriented approach. The enduring approach involves an initial combination of one or more commercial providers of market making services, and a set of existing market makers who face a mandatory backstop obligation.

The Authority's first step and highest priority in implementing its long-term vision for market making, is to amend the Electricity Industry Participation Code (2010) (Code) to address the backstop's expiry, by implementing a permanent mandatory market making backstop.

The Authority consulted stakeholders on its proposed Code amendment to introduce a permanent mandatory market making backstop from 1 December 2020 to 18 January 2021. The Authority has considered all submissions received and has decided to proceed with its proposal, with some minor amendments based on feedback received.

This paper sets out the decision made by the Authority to implement a permanent mandatory market making backstop, the process it followed to develop the subsequent amendment to the Code, submissions from stakeholders and next steps for implementing the change.

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1 The Authority has decided to amend the Code and formalise a market making backstop

1.1 In August 2020, the Authority decided to pursue a long-term vision for market making that secures the benefits of the previous arrangements while enhancing efficiency, improving trust and confidence in the market, and facilitating a service-oriented approach. The enduring market making approach:

(a) transitions, over a period of years, to an incentivised market making arrangement where market making services are performed by providers compensated on commercial terms; and

(b) ensures the integrity of market making services is maintained in the transition period through a combination of mandated market makers and commercial providers.

1.2 As part of the work on market making the Authority decided to amend the Code by inserting a permanent mandatory market making backstop. This Code amendment is one aspect of the ongoing work being done by the Authority on Hedge Market Enhancements.[1]

1.3 Consumers benefit from market making activity in a variety of ways. It allows retailers to offer consumers better deals on their electricity, helping to protect them from volatile spot prices. It also allows new retailers to manage their price risk, which reduces barriers to entry, helping to increase competition in the retail market.

1.4 The gradual introduction of a commercial market making scheme – in place of the current arrangements – is in the long-term interests of consumers. It will increase competition, boost the performance of the market, and help ensure that contract prices accurately reflect traders' view of the future. This in turn will increase trust and confidence in forward prices of electricity in the wholesale market. This benefits consumers by enabling market participants to manage their price risk more effectively.

1.5 The improvements will formalise the provision of this important service. These changes will take several years to bed in and will improve the efficiency of the forward price curve, and the robustness of the market making service. The new market making arrangements will involve an initial combination of one or more commercial providers of market making services, alongside existing market makers.

The proposal is positive for consumers and supported by robust analysis

1.6 The Authority has undertaken a cost-benefit analysis of the proposed changes.[2] The analysis is positive for consumers, both in the initial implementation of the mandatory backstop, as well as enabling the benefits from the long-term decision to introduce commercial market making.

1.7 The Authority considers its enduring approach to market making will benefit consumers because the mandatory backstop enhances market maker performance, which:

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

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[1] More information available at: https://www.ea.govt.nz/development/work-programme/risk-management/hedge-market-development/

[2] Available at: https://www.ea.govt.nz/assets/dms-assets/27/Consultation-Paper-Hedge-Market-Enhancements-Permanent-market-making-backstop.pdf

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

(c) allows for greater competition in the retail and generation markets.

The Authority's decision is part of a broader project to implement enduring market making arrangements

1.8 Market making has been an important part of the market for exchange traded electricity contracts since the market was initiated on the ASX in 2010. Trading ASX contracts produces the most useful and widely used forward price curve – the current price at which electricity can be bought and sold for future time periods. The futures market also provides an avenue for wholesale market participants to manage their wholesale market price risk. The presence of market making services contributes to the production of the forward price curve and the management of price risk.

1.9 The existing four market makers (Contact, Meridian, Genesis, and Mercury) each have an agreement with the ASX to provide market making services. As the regulator of the electricity industry and electricity markets, the Authority has always had an interest in the performance of these market making services.

1.10 In spring 2018 there was an unscheduled outage at Pohokura gas field coupled with low lake levels, which caused price volatility and large increases in near-term electricity futures contract prices. Spreads in the ASX futures market widened significantly and trading volumes reduced. Following the events of spring 2018, market making activities took significant time to restart following the period of high volatility.

1.11 Ahead of summer 2020, there were two forecast events that presented risk to the functioning of the electricity futures market (planned outages to the High Voltage Direct Current (HVDC) transmission link and concurrent gas supply outages). As a result, the Authority implemented an urgent Code amendment for the period 3 February 2020 to 3 November 2020. The dormant scheme was a backstop measure that would only be triggered into effect for one or more market makers if the performance standards set out in the Code amendment were not met. Market maker performance during the temporary backstop period was observed to be good. The urgent amendment was implemented to:

(a) support the forecast risks of disruption in the futures market in early 2020, including maintenance of the inter-island HVDC transmission line and gas supply outages; and

(b) increase confidence in the market, particularly among non-market maker participants, that risk management tools would be available at efficient prices during the known disruptions.

1.12 Market maker performance during the temporary backstop period was good. Service provision at existing obligations (volume and spread) has been relatively stable throughout a series of significant price shocks, and the arrangements were flexible to the challenges posed by the Covid-19 lockdown. Additionally, market makers increased their level of service in early 2020 with increases in volumes market made, and reduced bid-ask spreads.

1.13 The temporary backstop proved successful in providing stable market making services, has been flexible to the changing needs of the market, and is known and understood by the market.

1.14 While the temporary backstop obligation contributed to positive outcomes in the electricity futures market, the temporary obligation has expired. The Authority intends to continue mandated support for the current voluntary market making provisions, as part of its enduring market making approach.

1.15 Since the expiration, market making behaviour has further demonstrated the need to implement a permanent backstop. In February 2021, by the middle of the month a market maker had used all of its five exemption days permitted under its agreement with ASX. On 19 February that market maker was absent from the market for a sixth time that month. Had the backstop been in place, the absence would have counted as a strike under the backstop scheme and incentivised the market maker to ensure it provided a high level of service for the next ninety days.

1.16 The first step in the transition to the enduring arrangements will involve concurrent mandated and commercial providers of market making services. The mandated parties will be the existing market makers: Contact, Genesis, Mercury, and Meridian. The Code amendment (see Appendix A) will formalise the mandated requirements in the Code.

2 The Authority's decision has been informed by stakeholder engagement

2.1 The Authority had several rounds of formal engagement with stakeholders as it conducted its review of market making arrangements, including formal consultation processes, bi-lateral meetings, and meetings with groups of stakeholders.

2.2 Following the Board decision in August 2020, the Authority proposed a Code amendment. The Authority undertook formal consultation on the proposed change from 1 December 2020 to 18 January 2021. The Authority received submissions from the 11 parties listed in Table 1 below.[3]

Table 1: List of submitters

Submitter	Category
Contact	Generator/retailer/market maker/trader
Ecotricity, Electric Kiwi, Flick, Pulse, Vocus	Independent retailers
Electric Kiwi and Haast Energy Trading	Retailer/trader
emhTrade Markets	Trader
Genesis	Generator/retailer/market maker/trader
Major Electricity Users' Group (MEUG)	Large consumer representative group
Mercury	Generator/retailer/market maker/trader
Meridian	Generator/retailer/market maker/trader
Nova	Generator/retailer/trader

[3] Available at: https://www.ea.govt.nz/development/work-programme/risk-management/hedge-market-development/consultations/#c18742

Submitter	Category
NZX Limited	Exchange platform
Trustpower	Generator/retailer/trader

3 The Authority has amended its proposal in response to stakeholder submissions

3.1 The submissions the Authority received provided useful perspectives and contributed to minor changes to the Code amendment. Table 2 sets out the comments from stakeholders that resulted in changes to the Code amendment.

Table 2: Submitter comments and Authority response

Submitter comment	Authority response
Submitters had feedback on the open-ended mandatory backstop and several agreed that there should be an end point at which the market maker returns to the voluntary market after a period of good performance. Contact recommends the Authority gives a defined point of relief to a market maker who becomes subject to the backstop. Mercury recommends the exemption is reset following 90 periods of consecutive performance and Meridian advocates for a mechanism for market makers who have become subject to the backstop to return to voluntary market making if the relevant market making performance targets are met for a prescribed period of time, (eg, 6 months). Meridian notes that the regime as proposed has a permanent commercial disadvantage. The Independent Retailers did not think it was necessary at this time to introduce a mechanism for parties' subject to the mandatory backstop to cease being subject to it.	The Authority agrees that there should be a mechanism for market makers who have become subject to the backstop to return to the voluntary market after a period of good performance. When the Authority introduced the temporary backstop it was for a period of nine months at which point market makers had a natural end to their obligations. The Authority recognises the constraints mandatory market makers would face if they were continuously subject to the obligations of the mandatory backstop. After considering submissions, the Authority considers it appropriate that a market maker who faces the mandatory obligations should have the opportunity to have their obligations removed following a 90 day period of compliance. The Authority considers this will provide incentives for market makers to perform well both to remain in the voluntary scheme and to avoid being faced with the more stringent obligations in the mandatory scheme. This change is reflected in the final Code amendment attached as Appendix A.
NZX considers that the Code should be agnostic to both the venue and product for NZ electricity futures, otherwise it will be a barrier for alternative venues that may consider offering NZ electricity futures contracts.	The Authority agrees the Code should be market agnostic. The Authority has created a definition for 'exchange' which does not specify ASX as the exchange platform. The Authority will publish a list of exchanges that allow market makers to provide market making services. In line with its statutory objective, the Authority has a preference for promoting

Submitter comment	Authority response
	competition. The Authority notes the feedback that the Code amendment, as drafted, had the potential for establishing a precedent for futures trading on one market precluding market making on other exchanges. The updated Code amendment seeks to address this.
Contact noted a minor drafting error and suggested clause 13.236K(2)(c) be amended to read Clause 13.236K(2)(b).	The Authority has noted the technical suggestions and updated the amendment accordingly.

3.2 Table 3 below summarises other points made in the submissions that are either out of scope of the project, have been addressed previously, or will be addressed as the Hedge Market Enhancement work progresses.

Table 3: Submitter comments and Authority response

Submitter comment	Authority response
Some submitters (Electric Kiwi and Haast Energy Trading, the Independent Retailers and Mercury) expressed interest in seeing a detailed timeline for the Hedge Market Enhancement work, including the timeframe around commercial market making work.	The Authority has published a Request for Information (RFI)[4] seeking information and feedback from potential providers as it establishes a commercial market making scheme (the Scheme) for the electricity futures market in NZ. Upon completion of this RFI process, the Authority will further develop the Scheme design it wishes to procure. The Authority then intends to initiate a formal procurement process, by initially seeking Registrations of Interest (ROI) from interested parties, to then shortlist and seek proposals through a Request for Proposal (RFP). The Authority intends to work towards the following procurement timelines: • **March 2021**; RFI close and consideration of information; • **July – September 2021**; ROI open (6 weeks), open to any parties wanting to submit; • **October – December 2021**; RFP open (6 weeks), invited parties shortlisted from the ROI; and • **January – March 2022**; selection of commercial providers, commencement of commercial market making. The Authority requests feedback on specific aspects of the proposed design.

[4] Available at: https://www.gets.govt.nz/EA/ExternalTenderDetails.htm?id=23851919

Submitter comment	Authority response
Several submitters had feedback on the cost-benefit analysis (CBA) supporting the proposed Code amendment. Some submitters supported the CBA. MEUG agrees the proposed code amendment will have a positive net benefit for consumers and Nova, the Independent Retailers, Electric Kiwi, Haast Energy Trading, and emhTrade Markets are comfortable with the content covered in the CBA. emhTrade Markets notes some limitations to the CBA eg, lack of consideration of: • the cost/benefits and increased/decreased costs associated with market making services and the future procurement of commercial providers, • any alternatives to its recommendation that the expired emergency backstop effectively be reinstated ‘as is’ via Code amendment, • 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. Other submitters suggested improvements to the CBA. Electric Kiwi and Haast Energy Trading suggested extending the CBA to test whether tightening elements of the Code amendment could be expected to deliver greater increases in competition and long-term benefits to consumers. MEUG suggested the CBA could be enhanced by a survey of consumers to test if the proposal would affect confidence in hedge markets in general. MEUG suggest using the Herfindahl-Hirschman Index in future to increase the robustness of the CBA. Genesis and Trustpower do not believe the CBA provides a convincing basis for introducing the Code amendment, they note the lack of data availability resulting in inadequate quantitative analysis.	The Authority notes the feedback on the CBA. The Authority considers the independent CBA conducted by Sapere is sufficiently robust to support the proposed Code change. The Authority always welcomes suggestions on how to directly link its work to quantifiable impacts on consumers. The Authority notes that some of the points raised by emhTrade Markets are addressed in the design questions of the RFI.

Submitter comment	Authority response
The Authority received feedback on the bid-ask spread. Mercury suggested expanding the spread to 5% for monthly and two front quarter contracts.	As part of the RFI for the Scheme, the Authority is proposing a maximum bid-offer spread of 3% as the base case. The Authority is also interested in how the cost of provision would vary at different levels of spread and will consider feedback in the design of the Scheme and levy consultations later in 2021.
Nova highlighted the need to align the incentives between existing market makers and the commercial providers.	The Authority has explicitly considered the need to align incentives between existing and commercial market makers in the design of the RFI.
Electric Kiwi and Haast Energy Trading raised questions around the criteria for mandatory market makers. They suggested it should be on the basis of market power and vertical integration and consequently include Trustpower as the 5th largest generator.	The Authority considered this concern when it made its decision in August 2020 to include the four largest generator-retailer within the mandatory backstop.
Electric Kiwi and Haast Energy Trading raised concerns around transfer payment disclosure/retail-wholesale financial separation requirements.	The Authority is addressing these concerns in its response to the relevant Electricity Price Review recommendation (D3 – Make generator-retailers release information about the profitability of their retailing activities).
The Independent Retailers raised concerns that incumbent market makers have limited incentives or interest to offer, for example, day-time peak products.	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.
Mercury submitted that any subsequent market makers added under the transitional regime must add to liquidity and depth rather than replacing any of the existing volume obligations.	The Authority anticipates that, over time, the balance of service provision between commercial and regulated market makers will shift to include more volume provided by commercial providers, and less volume provided by regulated providers. The Authority's long-term approach may result in full provision of market making services by commercial providers. Regulated market makers are not restricted from also providing market making services on a commercial basis. The design of the Scheme will continue to develop throughout 2021.
Genesis noted that the Authority could implement a temporary backstop urgently	The Authority considers that a permanent mandatory backstop will provide necessary

Submitter comment	Authority response
if there was risk of market disruption/failure and that a permanent backstop is not necessary.	certainty to market participants, and wider stakeholders including potential commercial market makers. While the Authority could implement temporary backstops urgently as required, it would not provide the same level of certainty and therefore stability to the market, which is preferable.
In the feedback there was a request that the Authority have discretion to take third party issues into consideration and relieve the participant of the effects of subpart 5B of the proposed amendment if the participant can prove that third party issues contributed to them failing their market making obligations.	The Authority considers that management of third-party performance is largely under the control of the market makers. The Authority considers the number of exemptions is appropriate.
Submitters provided feedback on the exemptions. Mercury and Meridian both sought a change to match the exemptions in the mandatory market to existing voluntary arrangements (5 rather than 2). Meridian stated the backstop has the potential to operate punitively if it was not the same.	The Authority notes the concerns and considers that allowing market makers to return to the voluntary market after a period of good performance mitigates this concern. The mandatory backstop provides the appropriate incentives to ensure market makers provide the desired level of service.
emhTrade Markets noted the Regulatory Statement conflates hedge market strategy with this Code change and was silent on alternatives to this Code change as part of this strategy.	The purpose of the Code change is to improve the apparent lack of confidence in the market for exchange-traded futures in general, and in market making services in particular; and to improve their reliability. The Authority assessed some options to address the objectives. However, the other options were not suitable for addressing the objectives. The selected proposal will provide necessary certainty to market participants, and wider stakeholders including potential commercial market makers.

4 Next steps

4.1 The Code amendment will come into force on 27 April 2021, following the 28-day Gazette period.

4.2 The Authority will continue to develop a commercial market making approach to improve and strengthen existing market making arrangements for the long-term benefit of consumers.

4.3 As part of the process to set up the commercial market making scheme, the Authority invited local and international organisations interested in providing commercial market making services to provide feedback on the proposed scheme through an RFI. The RFI closed on 12 March 2021.

4.4 Information received through the RFI will help to inform the final design, procurement and establishment of the commercial market making scheme. The scheme design will be finalised for a Request for Proposal (RFP) in late 2021.

5 Attachments

5.1 The following item is attached to this paper:

(a) Permanent mandatory market making backstop Code amendment

Appendix A Permanent mandatory market making backstop Code amendment

1 Clause 1.1 amended

(1) In clause 1.1(1), insert in their appropriate alphabetical order:

"**exchange** means an exchange included in a list **published** by the **Authority** on which New Zealand electricity base load futures contracts are available for trade

"**NZ electricity future** means a New Zealand electricity base load futures contract in respect of the Otahuhu reference **node** or the Benmore reference **node** available for trade on an **exchange**"

(2) In clause 1.1(1), replace the definition of **bid-ask spread** with:

"**bid-ask spread** means—

(a) if expressed as a dollar value, the dollar value that represents the difference in price between a **quote** to buy a **NZ electricity future** and a **quote** to sell a **NZ electricity future** of the same type on the same **exchange**; or

(b) if expressed as a percentage, the percentage calculated by dividing the difference between the price of a **quote** to buy a **NZ electricity future** and the price of a **quote** to sell a **NZ electricity future** of the same type on the same **exchange** by the price of the **quote** to sell a **NZ electricity future**"

(3) In clause 1.1(1), replace the definition of **NZEF market-making agreement** with:

"**NZEF market-making agreement** means an agreement between a **participant** and an **exchange** that imposes obligations on the **participant** in relation to the **exchange's** daily settlement market-making scheme for **NZ electricity futures**, in the form of agreement used on the **exchange** for this purpose that is satisfactory to the **Authority**, having regard to its inclusion of the requirements set out in clause 13.236L and of the permitted exemptions from the performance of market-making services"

(4) In clause 1.1(1), replace the definition of **NZEF market-making period** with:

"**NZEF market-making period** means from 1530 to 1600 New Zealand time on each **business day** on which **NZ electricity futures** are traded"

(5) In clause 1.1(1), replace the definition of **quote** with:

"**quote** means an offer to buy or sell a **NZ electricity future** on an **exchange**"

2 Heading above clause 13.236J replaced

Replace the heading above clause 13.236J with:

"Subpart 5B—Hedge market arrangements"

3 Clause 13.236J replaced (Contents of this subpart)

Replace clause 13.236J with:

"**13.236J Contents of this subpart**

This subpart provides for an active market for trading financial hedge contracts for **electricity** by specifying requirements for certain **participants**."

4 Clause 13.236K replaced (Application of subpart)

Replace clause 13.236K with:

"**13.236K Application of subpart**

(1) Subject to subclause (2), this subpart applies to the following **participants**:

(a) Contact Energy Limited;

(b) Genesis Energy Limited;

(c) Mercury NZ Limited;

(d) Meridian Energy Limited.

(2) This subpart applies to a **participant** specified in subclause (1) if that **participant**–

(a) is not a party to a **NZEF market-making agreement** that includes the requirements set out in clause 13.236L; or

(b) does not perform market-making services in accordance with the **NZEF market-making agreement** on three or more separate occasions in a period of 90 days, and that non-performance is not permitted by an exemption or otherwise under the **NZEF market-making agreement**.

(3) A **participant** to whom subclause (2) applies is relieved of its obligations under this subpart when the **Authority**:

(a) is satisfied that the **participant** has complied with its obligations under this subpart for a period of 90 days; and

(b) has given written notice to that effect to the **participant**, which the **Authority** must do within 5 **business days** of being satisfied as to compliance."

5 Clause 13.236L replaced (Requirement to quote)

Replace clause 13.236L with:

"**13.236L Requirement to quote**

(1) Subject to subclause (3), the **participant** must, for a minimum of 25 minutes in every **NZEF market-making period**, provide **quotes** to buy and sell a minimum of—

(a) 30 monthly base load futures contracts for each of the Otahuhu reference **node** and the Benmore reference **node** (being 30 buy and 30 sell for each reference **node**) for the current month and each of the five months following the current month; and

(b) 30 quarterly base load futures contracts for each of the Otahuhu reference **node** and the Benmore reference **node** (being 30 buy and 30 sell for each reference **node**) for each quarter that is available for trade on an **exchange**.

(2) The **participant** must not provide a **quote** under subclause (1) with a **bid-ask spread** that exceeds the greater of 3% or NZ$2.

(3) The quantity of buy or sell **quotes** the **participant** must provide under subclause (1) for each **NZEF market-making period** is reduced by the number of contracts of the same type bought or sold by the **participant** during that **NZEF market-making period**."

6 Clause 13.236N replaced (Exemptions from requirement to quote)

Replace clause 13.236N with:

"**13.236N Exemptions from requirement to quote**

(1) The **participant** is exempt from the requirements in clause 13.236L in the following circumstances:

(a) for a **NZEF market-making period** if—

(i) the **participant** cannot comply with a requirement in clause 13.236L in that **NZEF market-making period** because an **exchange** trading platform is disrupted or unavailable; or

(ii) in the reasonable opinion of the **participant**, entering into a contract for a **NZ electricity future** in that **NZEF market-making period** may cause the **participant** to breach an applicable law;

(b) in addition to the exemptions in paragraph (a), for up to two **NZEF market-making periods** each month at the **participant's** discretion.

(2) To avoid doubt, if the **participant** meets the criteria for exemption in subclause (1)(a)(i) or (1)(a)(ii) in relation to a **NZEF market-making period**, that **NZEF market-making period** will not count towards the **participant's** two exemptions in subclause (1)(b).

(3) If the **participant** relies on an exemption under this clause 13.236N from the requirement to **quote**, the **participant** must immediately notify the **Authority** of the exemption it has relied on and the basis for the exemption."

Explanatory Note

This note is not part of the amendment, but is intended to indicate its general effect.

This amendment to the Electricity Industry Participation Code 2010 (Code) comes into force on 27 April 2021. The amendment inserts a new subpart 5B of Part 13 into the Electricity Industry Participation Code 2010 ("Code") and new definitions into Part 1 of the Code. The new subpart describes a scheme that, if triggered into effect for one or more specified participants by the occurrence of specified events, will facilitate an active market for trading financial hedge contracts for electricity. The scheme will do so by imposing certain market-making obligations on one or more of Contact Energy Limited, Genesis Energy Limited, Mercury NZ Limited and / or Meridian Energy Limited if their respective actions or inactions trigger the application of the scheme to them.