

29 November 2019

Fraser Whineray
Chief Executive
Mercury
PO Box 90399
Auckland 1142

By email: [REDACTED]

Dear Fraser,

Improving market performance and transparency

Thank you for taking the time to meet with the Authority last week. This letter follows up our conversation.

Information and data about the market is critical to understanding its performance, and providing confidence in that performance. A well functioning market that participants have confidence in helps to ensure efficient prices and supports the best possible outcomes for consumers.

Several of the EPR Panel's final recommendations related to ensuring sufficient information and data is available to the market so that participants:

- can actively compete on a level playing field with other participants
- can have confidence they are competing on a level playing field with other participants.

The Authority is actively working on the Government's response to the EPR's recommendations and is considering what other measures may be useful in this regard. In respect of recommendations related to the hedge and spot markets, for example, the Authority is continuing its monitoring activities and has introduced a new stress test scenario in response to planned outages of the HVDC link, Ahuroa gas storage and Pohokura gas field in Q1 2020. This type of proactive measure is intended to ensure every market participant has all the information available to them about possible market risks, so that they can take appropriate action.

The Authority considers that steps can be taken now to improve market making services

In this context, the Authority is considering what changes could be made to the current market making arrangements to improve performance of, and confidence in, the exchange traded futures market particularly in the near term. The Authority has a consultation underway to determine what, if any, more permanent Code changes would have long-term benefit for

consumers. Your participation in this consultation will be very important as what we do has to be based on solid information and analysis. We look forward to analysing your submissions.

The Authority considers that the following changes to market making services will help to provide ongoing confidence to the market:

- reduce the bid-ask spread to no more than 3%
- increase the volume of all contracts with market making to 3MW.

The bid-ask spread of market made contracts is a key metric of market performance and it greatly influences the experience of purchasers and their confidence in the market. The current market making arrangements require a bid-ask spread of no more than 5%. During periods of normal market activity this has resulted in observed spreads of around 4%.

The Authority has long been aware of calls for tighter bid-ask spreads and accepts there would be many benefits to doing so. In addition to increasing confidence in the efficiency of prices, a tighter bid-ask spread could reduce prudential requirements over time and will facilitate greater trading by non-market making parties. At this point in time we consider market making arrangements with a bid-ask spread of no more than 3% to be appropriate. This figure was recommended by the Authority's Wholesale Advisory Group in 2015.

When market makers each agreed to a new market making agreement with the ASX earlier this year the Authority raised concern that the volume of contracts offered to market was materially reduced. We have not seen evidence of a lack of volume *per se* and note the ASX has produced analysis showing there are few days in which contracts are not available for trade at the end of each trading day. However, the reduced volume has impacted the depth of the market, and this appears to have had a material impact on purchasers' confidence in it. In particular, some participants have reported that a lack of depth is causing material changes in price when even small volumes are transacted.

Accordingly, the Authority considers that an increase to the volume of contracts offered pursuant to the market making arrangements to 3MW across the board is likely to improve market confidence. This shift requires all market makers to increase monthly and near-term quarterly contracts to 3MW.

The Authority is actively progressing an urgent Code amendment before the end of December 2019. The urgent amendment would impose mandatory obligations upon existing market makers in the event that voluntary measures, including those described above, are not being met. The Authority's current view is an urgent code amendment is in the public interest as greater market confidence is needed in the near term to mitigate risks presented by known disruptions in early 2020.

The Authority considers that it should send a clear signal of its expectations to inform any bi-lateral discussions that each market maker may need to have with the ASX. We are aware of recent allegations of anti-competitive conduct in relation to the market makers. We remind parties that discussions with the ASX should be held separately and independently of each other to avoid any risks of anti-competitive conduct when dealing with these issues. The Commerce Commission has indicated that it is willing to provide market makers with further guidance on these matters, if necessary.

The Authority is seeking greater transparency

A contributor to the current lack of confidence in market outcomes by some parties, and the subject of a recommendation by the EPR Panel, is a perception that large generator retailers are pricing their retail offers below cost. This would force non-integrated retailers to choose

between raising prices to cost-reflective but uncompetitive levels, or pricing their retail offerings below cost. If this occurs on a sustained basis it could result in otherwise efficient businesses leaving the market – to the detriment of consumers.

The Authority would like to understand the internal transfer price for energy between all generation and retail businesses by market segment. The Authority will be continuing our recent discussions with a view to putting in place standardised reporting of transfer prices and profit.

More complete and better information supports the Authority’s market development process. Better information leads to better decisions. The Authority would like all market makers to provide authority to the ASX so that it can provide us your deanonymised bidding, offering and trading data. These data will enable us to track market making activities and trends. It will also allow the Authority to publish market making performance reports – at a suitably abstract level – which will give confidence to non-market making participants of the performance of the market.

Next steps

The Authority considers all these measures can be introduced by the end of the calendar year. The Authority’s Board is meeting on Wednesday 18 December and will consider the progress made on the requests outlined in this letter and what options are available to it if sufficient progress is not made.

I have shared a copy of this letter with the ASX and will be publishing it on our website.

Yours sincerely



James Stevenson-Wallace
Chief Executive

cc: Marc England- [REDACTED]
Neal Barclay- [REDACTED]
James Kitty- [REDACTED]
Catherine Thompson- [REDACTED]
Head of Strategic Delivery Capital Markets at ASX