

18 January 2021

Tom Georg  
Manager Wholesale Markets  
Electricity Authority  
By email to [HME.feedback@ea.govt.nz](mailto:HME.feedback@ea.govt.nz)

Dear Tom

### Consultation paper – Permanent market making backstop

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Electricity Authority (EA) consultation paper "Hedge Market Enhancements – Permanent market making backstop" 24<sup>th</sup> November 2020.<sup>1</sup> Consultation paper paragraph numbers and Sapere cost-benefit-analysis (CBA, Appendix A of the consultation paper) page numbers are referred to in square parenthesis.
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. MEUG agrees with the summary of the purpose for and benefits and costs of the proposed amendment set out in the Regulatory statement in Appendix B (question 2 [6.8]) and supports the proposed Code amendment in Appendix C (question 3 [6.8]).
4. In response to question 1 [6.8] seeking feedback on the CBA, MEUG agrees the proposed Code amendment will have a positive net benefit for consumers as set out in the sections headed:
  - "This first step in the implementation process has net benefits for consumers" [6.1] and [6.2].
  - "This initial step allows the benefits of the overall decision" [6.4] and [6.5].
5. Additional commentary on the CBA follows:
  - a) MEUG agrees a narrow scope of the CBA is appropriate to consider the proposed Code amendment as set out in Sapere [pii]:

*"What we are looking to assess in this case is the change in 'control' between a strictly voluntary regime and a mandatory regime that works alongside a voluntary arrangement."*

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<sup>1</sup> URL <https://www.ea.govt.nz/assets/dms-assets/27/Consultation-Paper-Hedge-Market-Enhancements-Permanent-market-making-backstop.pdf> at <https://www.ea.govt.nz/development/work-programme/risk-management/hedge-market-development/consultations/?ct=t%28Market+Brief+-+24+November+2020%29#c18742>.

In our view Sapere correctly separate the CBA required in this instance from the broader question of whether to have market making or not.

- b) Missing in the Sapere paper is a discussion of the effect of the proposed Code amendment on the broader problem of low consumer confidence in the market in general. The Regulatory statement does refer to consumer confidence in that broader context in [B.1(a)] in listing key issues to be addressed by market making:

*“the apparent lack of confidence in the market for exchange-traded futures in general, and in market making services in particular.”*

We agree with the view in the Regulatory Statement that confidence in the market for exchange-traded futures in general are relevant factors that need to be considered in policies to improve competition in hedge markets. Market making being one of the important policies in the latter.

Confidence in the market has been on a downward trajectory for some time. The December 2020 decision on the UTS event in late 2019 being notable as confirming concerns by many parties including MEUG on the behaviour of some suppliers in certain circumstances.

MEUG is mindful that:

- ~ There is no single silver bullet to improve competition; and
- ~ Improvements to market making and other policy levels such as information disclosure and monitoring need to be considered and carefully implemented to avoid regulatory overreach and other unintended consequences.
- ~ Undertaking a CBA on discrete policies to improve competition is non-trivial.

Nevertheless, in assessing proposals in a CBA we recommend an assessment on the confidence of consumers be made on both the effect of the specific policy change and confidence in the market, bearing in mind what matters is the long-term benefit of consumers. For the CBA to assess the proposed Code change a survey of consumers to test if the proposal would affect confidence in hedge markets in general could have been undertaken.

- c) The discussion on problem definition in Sapere [p4-5] refers to “market failure” in the hedge market (assumed to be read as the ASX future market) because that market will be illiquid if there is no market making. MEUG suggests caution is needed when describing a policy problem as being a “market failure.” Often policy makers, Crown entities (eg EECA) and other parties glibly refer to a problem as being a “market failure” when it does not meet the usual economic definition and is simply used as a phrase to assign a status to a problem that is not actually a true economic “market failure.” MEUG is not suggesting that issue arises in the CBA as we agree there is an economic market failure of “asymmetric information” as described in Sapere [p4, last bullet point].

There is another possible issue to be considered though. That is there might be an economic market failure not considered in the CBA because that is outside the narrow scope of the proposed Code amendment and the observed illiquidity risks in the futures market are a symptom of that more fundamental true economic market failure. For example, a hypothesis that should be tested is that there is an economic market failure because of monopoly/oligopoly power at a structural level that manifests itself in the observed market failure of “asymmetric information” in the hedge markets as described in Sapere [p4, last bullet point].

- d) Several measures of competition are set out in [Sapere p10-15]. There are other measures that are also used such as the Herfindahl-Hirschman Index (HHI) and analysis of economic profits<sup>2</sup>. We mention this because the CBA is helpful but should not set a precedent for the only measures to be considered in future CBA.

Yours sincerely



Ralph Matthes  
Executive Director

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<sup>2</sup> MEUG is currently undertaking a pilot analysis of Meridian Energy Limited economic profits over the last 20 years.