MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

Minister	Hon Dr Megan Woods	**Portfolio**	Energy and Resources
Title of Cabinet paper	Electricity Authority levy increase funding the commercial market making scheme	**Date to be published**	9 November 2021

List of documents that have been proactively released		
Date	**Title**	**Author**
September 2021	Electricity Authority levy increase funding the commercial market making scheme	*Office of the Minister of Energy and Resources*
22 September 2021	Cabinet minute DEV-21-MIN-0180	*Cabinet Office*

Information redacted **YES / NO**

Any information redacted in this document is redacted in accordance with MBIE's policy on Proactive Release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Some information has been withheld for the reason of Commercial information.

In Confidence

Office of the Minister of Energy and Resources

Cabinet Economic Development Committee

Electricity Authority levy increase: funding the commercial market-making scheme

Proposal

1 I seek approval to increase the Electricity Authority's appropriation by $3.6 million in 2021/22 and $14.4 million per year from 2022/23, to enable the Electricity Authority (Authority) to proceed with implementation of a commercial market-making scheme. The proposal is cost neutral to the Crown as the costs will be recovered through an increase to the existing levy on electricity industry participants.

Relation to government priorities

2 This proposal relates to the Government's commitment to implementing the Electricity Price Review's recommendations, specifically the recommendation to introduce mandatory market-making obligations unless the sector develops an effective incentive-based scheme.

Executive Summary

3 The Electricity Price Review found that the New Zealand electricity market would benefit from stronger competition and recommended that the Authority introduce mandatory market-making obligations unless the electricity sector developed an effective incentive-based scheme. At the same time the Authority was moving to correct a market failure that became apparent following an unscheduled outage at the Pohokura gas field in 2018.

4 The Authority is now progressing work that will help strengthen and support operation of the electricity futures market. The proposed approach is to develop a commercial market-making scheme which will operate alongside existing regulated market makers (the largest four generator-retailers[1]). The Authority's consultation process confirmed a commercial scheme as being the best way to achieve this.

[1] Contact Energy, Genesis Energy, Mercury and Meridian Energy.

5 The Authority is fully levy funded and is currently appropriated about $80 million per year for its operations. The commercial market-making scheme is expected to cost an additional $14.4 million per year.

6 To deliver this scheme the Authority needs an “out of cycle” appropriation increase for 2021/22 to begin the procurement process as soon as possible, and an annual increase from 2022/23.

Background

7 The Authority is an independent Crown entity responsible for overseeing and regulating the New Zealand electricity market.

8 The Authority regulates the electricity market by developing and setting market rules, enforcing and administering them, and monitoring performance..

9 In 2018, I commissioned the Electricity Price Review (EPR), which was tasked with investigating whether the electricity sector is delivering fair and equitable prices to consumers. The EPR found that New Zealand’s electricity industry works well in many respects, but consumers would benefit from stronger competition, fairer and more efficient pricing, and more openness to new technologies.

10 One of its 32 recommendations was to introduce mandatory market-making obligations unless the electricity sector developed an effective incentive-based scheme. At the same time, the Authority was moving to correct a market failure that became apparent following an unscheduled outage at the Pohokura gas field in 2018.

11 The Authority has consulted and made decisions on an approach to market-making in the electricity futures market. The proposed approach is a commercial market-making scheme that will help strengthen and support the operation of the electricity futures market, enhance efficiency, and improve trust and confidence in the price of electricity futures.

12 The commercial market-making scheme will operate alongside existing regulated market makers. The Authority needs an increase to its 2021/22 appropriation to begin delivery the scheme soon, and an annual increase from 2022/23 for ongoing delivery of the scheme.

13 I have already agreed to the Authority’s appropriation for 2021/22, and the levy rates have been set. However, the Electricity Industry Act 2010 and the associated levy regulations provide for changes to be made to the appropriation and levy rates during a financial year following consultation. I am therefore seeking an “out of cycle” increase for 2021/22, and ongoing appropriation increase from 2022/23.

Policy

14 The new commercial market-making scheme will enhance the performance of the wholesale electricity market by strengthening and supporting the operation of the electricity futures market, enhancing efficiency, and improving trust and confidence in forward prices.

15 The Authority has consulted on implementation of the scheme and on how the costs will be recovered from industry participants. It now requires certainty of funding to enable it to enter into commercial agreements early in 2022.

The wholesale electricity market

16 The spot and hedge market are the major components of the wholesale electricity market. Electricity is purchased and sold on the wholesale spot market where prices are calculated every half-hour and vary depending on supply and demand, and the location on the national grid.

17 In addition to buying electricity directly from the spot market, retailers and large industrial users can also enter into financial contracts, often called hedges or hedge contracts, which smooth out some or all of the volatility in spot prices. There are three types of hedge markets in New Zealand: over the counter, ASX market (futures market) and financial transmission rights.

18 For retailers and large industrial users, a hedge is a form of insurance against variable spot electricity prices. Equally, generators benefit from gaining certainty as to the price they can sell electricity.

Market-making and its role in the hedge market

19 Since the establishment of the futures market in 2010, the four large generator-retailers – Contact, Genesis, Mercury and Meridian – have voluntarily provided market-making services by offering to buy and sell futures contracts for a specific trading period each day. Providing this service comes at a cost that these companies are currently not compensated for.

20 Large consumers benefit from market-making activity directly as they can purchase contracts to manage their price risk. Residential and other small consumers benefit from market-making activity indirectly, as these services allow retailers to manage future price risk through hedging. Retailers can offer fixed price deals to consumers, helping to protect them from volatile spot prices.

21 While the voluntary arrangements have provided benefit to consumers over time, there have been periods of significant disruption, for example, when the 2018 Pohokura gas outage coincided with a dry year.

22 The low hydro storage levels and tight gas supply at the time created spikes in the spot price for electricity. This prompted at least one of the four generator-retailers to withdraw from market-making, citing “portfolio stress”. The others quickly followed, which rapidly led to significant price spreads and muffled price signals.

23 The EPR found that while voluntary arrangements had supported strong growth in the volume of fixed-price contracts traded and improved retail competition, the contract market had become increasingly fragile. It acknowledged that market-makers should not be required to assume undue risks, but found that individual market-makers were making participation decisions without any visibility of the criteria used to arrive at their decisions, or on whether they had withdrawn. Once one market-maker withdrew, the likelihood was that others would follow. This voluntary arrangement rendered market-making fragile and unpredictable.

24 The EPR noted that it was vital to correct this fragility and protect the competitive process, and recommended the introduction of mandatory market-making obligations unless the electricity sector developed an effective incentive-based scheme. An efficient contract market is particularly important for stand-alone retailers and generators, which are a key source of innovation and competitive pressure.

25 The Authority has since worked with market-makers to improve the performance of the wholesale and hedge markets. In April 2021, the Authority amended the Electricity Industry Participation Code 2010 to include provisions for a mandatory market-making backstop. This is a move away from the voluntary scheme – the amendments set out a dormant scheme that can be triggered into effect for one or more of the four regulated market-makers does not meet performance standards set out in the Code.

26 The next step to enhance performance is to establish a commercial scheme, where commercial market-makers receive payment for services provided. The commercial scheme is part of the Authority’s long-term approach to market-making, which involves a deliberate transition, over several years, to commercial providers. This paper is about how that commercial scheme is funded.

The commercial market-making scheme

27 The Authority intends to transition to a market-making arrangement where market makers are compensated on commercial terms for the services they provide.

28 The addition of commercial market-making service providers will help strengthen and support the operation of the electricity futures market, enhance efficiency and improve trust and confidence in forward prices of electricity in the wholesale market.

29 The Authority reached this decision following several rounds of formal engagement with stakeholders, as it conducted its review of market-making arrangements. The engagement included formal consultation processes, bi-lateral meetings, and meetings with groups of stakeholders.

30 A diverse range of electricity market participants engaged in the various stages of consultation. Participants included independent retailers, large industrial users, integrated generator-retailers and financial intermediaries.

31 The Authority wishes to ensure market participants continue to benefit from the forward price curve and are able to access risk management contracts. The Authority's consultation process confirmed a commercial scheme as being the best way to achieve this. Implementing a commercial scheme will mean a less volatile futures market and greater availability of risk management contracts. These benefits will outweigh the cost of procuring commercial market makers.

32 The cost of commercial market-making will offset part of the costs of market-making services that are currently being performed by the existing market makers without compensation.

Providing funding certainty for the Authority

33 All of the Authority's activities must be fully funded by levies collected from electricity industry participants under section 128 of the Electricity Industry Act 2010. It is currently appropriated about $80 million per year for its operations.[2] The commercial market-making scheme is expected to cost an additional $14.4 million per year.

2 This includes about $40 million per year to pay for system operator services provided by Transpower to operate the power system in real-time, including scheduling and dispatching electricity, in a manner that avoids undue fluctuations in frequency and voltage on the transmission grid.

34 The expected cost is based on the Authority's view of the expected maximum cost of procuring market-making services. It is informed by data provided by potential suppliers to a January 2021 Request for Information (RFI). The RIF outlined the expectation that the commercial market-maker/s will provide a total volume per future product of 2.4 MW in the first iteration (20 percent of 12 MW, with the remainder provided by regulated market-makers) with a maximum spread of the greater of 3 percent and $2 per MWh between the bid and ask price. Commercial Information [redacted]

35 The first annual contract under the scheme will span three months of 2021/22 and nine months of 2022/23, and the financial impact of the first contract will be $3.6 million in 2021/22 and $10.8 million in 2022/23.

36 However, I have already agreed to the Authority's appropriation for 2021/22 and the associated levy rates have already been set. Section 129(1) of the Electricity Industry Act 2010 provides for appropriation changes during a financial year if there has been appropriate consultation. The Authority's June 2021 levy consultation on the scheme meets this requirement.

37 I therefore seek agreement to an "out of cycle" appropriation increase of $3.6 million in 2021/22 and a $14.4 million per year increase from 2022/23 (which includes $10.8 million in 2022/23 towards year one of the scheme). This will provide the Authority with funding certainty so it can enter commercial contracts for the first year of the scheme later in 2021, with commercial market-making then taking effect from 1 April 2022.

38 If the increases are approved, the already set levy rates for 2021/22 will be revised to recover the increase, as provided for in the Electricity Industry (Levy of Industry Participants) Regulations 2010 (the levy regulations). Increases in subsequent years will be included in the levy rates set (typically in May each year) following industry consultation on the level of funding for all of the Authority's activities, and approval by the Minister of Energy and Resources.

39 Under the levy regulations, the Authority's costs are allocated to the different types of industry participants depending on who benefits from the activity.

40 In this case, the levy increase would be passed on to both generators and "purchasers" (i.e. retailers and large consumers that purchase from the wholesale market). The $14.4 million increase is estimated to add an average of $1.50 to each residential customer's bill per year. The increase in costs on the residential customers' bills will be outweighed by the benefit received in the futures market by a more accurate and robust trading environment for electricity futures.

41 Depending on the performance of the initial commercial market-making contract, the Authority may propose to increase the level of market-making services provided by commercial market makers in future. Any resulting increase in cost above the $14.4 million per year increase proposed in this paper will require a further increase in appropriation.

42 Future costs of the commercial market-making scheme will be included in the Authority's annual levy consultation, and I will continue to make decisions on the final appropriations for 2022/23 and beyond based on the Authority's post-consultation advice.

Implementation

43 The Authority will initially engage commercial market makers to take on 20 per cent of the total market-making obligation. The Authority's procurement of market makers is planned to have started by September 2021 (contingent on Cabinet agreement to the increase in funding), with commercial market-making expected to commence on 1 April 2022.

44 Implementing the commercial scheme aligns with the recommendations of the Electricity Price Review, and addressing market-making is one of the priorities I placed on the Authority in my letter of expectations to the Authority in December 2019. Advancement of procurement for the scheme is in the best interests of electricity market consumers, and it should start before the 2022/23 financial year.

45 I will receive an update from the Authority with the results of the commercial market maker procurement in early 2022. The scheme will be reviewed on an annual basis as part of the Authority's levy consultation.

Financial Implications

46 The Authority is fully levy funded and is currently appropriated about $80 million per year for its operations. Any approved increase will be recovered through the levy on electricity industry participants, and is therefore fiscally neutral to the Crown.

Legislative Implications

47 The implementation of commercial market-making and the associated increase in the levy do not require amendments to primary or secondary legislation.

Impact Analysis

Regulatory Impact Statement

48 The implementation of commercial market-making and the associated increase in the levy do not require amendments to primary or secondary legislation and therefore a regulatory impact statement does not apply.

Climate Implications of Policy Assessment

49 The implementation of commercial market-making and the associated increase in the levy do not include proposals to lower greenhouse gas emissions as a key policy objective or have a direct emissions impact. Therefore a climate implications of policy assessment does not apply.

Population Implications

50 There are no specific population implications.

Human Rights

51 There are no human rights implications arising from these proposals.

Consultation

52 The following departments have been consulted on this paper: The Treasury and Electricity Authority.

53 There has been extensive consultation with industry participants and other stakeholders throughout the development of the market-makings scheme (as summarised earlier). The Authority undertook four rounds of consultation between November 2019 and May 2021. Electricity industry participants provided feedback in written form. Specific consultation on the cost of the scheme was undertaken between 25 May and 22 June 2021.

Communications

54 The Authority has been keeping industry participants and stakeholders updated on progress, and will update stakeholders once decisions have been made.

Proactive Release

55 This paper will be published on the Ministry of Business, Innovation and Employment's website, subject to any redactions consistent with the Official Information Act 1982.

Recommendations

The Minister for Energy and Resources recommends that the Committee:

1 note the Electricity Authority is an independent Crown entity responsible for overseeing and regulating the New Zealand electricity market;

2 note one of the Electricity Price Review's recommendations was to introduce mandatory market-making obligations unless the electricity sector developed an effective incentive-based scheme;

3 note the Electricity Authority has since worked with market-makers to improve the performance of the wholesale market, and the next step to enhance performance is to establish a commercial scheme where commercial market-makers receive payment for services provided;

4 note the commercial market-making is expected to cost about $14.4 million per year, and the first annual contract will span three months of 2021/22 and 9 months of 2022/23;

5 note to deliver the commercial market-making scheme without delay, the Electricity Authority needs an "out of cycle" increase to its 2021/22 appropriation as I have already agreed to its appropriation for 2021/22;

6 note the Electricity Industry Act 2010 and the associated levy regulations provide for change to be made to the appropriation and levy rates during a financial year following consultation;

7 note the proposed increases are cost neutral to the Crown as the costs will be recovered through an increase to the existing levy on electricity industry participants;

8 agree to an "out of cycle" appropriation increase of $3.6 million in 2021/22 so that delivery of year one of the commercial market-making scheme can commence;

9 agree to an annual appropriation increase of $14.4 million from 2022/23, (which includes $10.8 million in 2022/23 for the remaining cost of year one of the scheme) to provide funding certainty for the Electricity Authority;

10 note that the Electricity Authority may increase the level of commercial market-making services in future, but that this would follow consultation with levy payers on the associated cost and a recommendation to the Minister of Energy and Resources on its annual appropriation;

11 approve the following changes to appropriations to give effect to the decisions in recommendations 8 and 9 above, with no impact on the operating balance and net core Crown debt:

	$m - increase/(decrease)				
Vote Business, Science and Innovation Minister of Energy and Resources	**2021/22**	**2022/23**	**2023/24**	**2024/2025**	**2025/26 and outyears**
Non-Departmental Output Expenses: Energy and Resources: Electricity Industry Governance and Market Operations	3.600	14.400	14.400	14.400	14.400
Total	3.600	14.400	14.400	14.400	14.400

12 agree that the proposed change to the appropriation for 2021/22 above be included in the 2021/22 Supplementary Estimates and that, in the interim, the increase be met from Imprest Supply.

Authorised for lodgement

Hon Dr Megan Woods

Minister of Energy and Resources