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Attached is the first of three short articles giving 'Perspectives of a new entrant electricity retailer'. These articles address subjects that materially impact our ability to retail in the New Zealand electricity market.

- The Hedge Market
- Scarcity pricing, and
- Prudential security

Introduction

Simply Energy is an independent relatively new entrant to the New Zealand electricity generation and retail supply market. Established in 2005 they have built a specialist business supplying electricity to commercial and industrial end users, purchasing off independent generators and arranging direct sales between generators and end users.

Their experience in building a retail business from the ground up has given Simply Energy a unique perspective on the challenges facing new entrants and by extension, competition in the New Zealand electricity market.

This is the first article in a series of 'perspectives of a new entrant retailer'

Problems with the hedge market

A moribund hedge¹ market makes life very difficult for a new entrant generator retailer, sometimes in ways that are not immediately obvious.

We see large variations in hedge pricing offered to end users. We believe this is in part due to a lack of transparently traded hedge instruments to provide a market consensus view on forward prices and volatility.

The trading, albeit very light, of base load contracts on the ASX has gone some way to improving forward market information by providing a measure of basis risk between the major grid exit points.

However we still lack a direct measure of volatility, for example a cap contract, and liquidity to give confidence that the prices are real.

info@simplyenergy.co.nz
P 0508 4SIMPLY
P 0508 474 6759
F (04) 473 9805

Wellington Office
Level 4, James Cook Arcade
294-296 Lambton Quay

Auckland Office
196a Jervois Road
Ponsonby

PO Box 8043
The Terrace
Wellington 6143
New Zealand

¹ When we talk about hedges we are referring to financial contracts for difference.

Variation in wholesale prices offered is compounded by undisciplined retail pricing. We have seen some of the larger retailers offer fully delivered retail power at prices below wholesale prices at certain times; it is hard for a new entrant to compete with product offered at below the prevailing wholesale cost.

From the perspective of a specialist retailer, hedge products that are available have the following problems:

- Contracts sizes are too big (ASX 1MW, Energyhedge 0.25MW). Contract sizes that enable new entrants to better match customer loads with a hedge book would help, for example a notional volume of 0.1MW.
- Nodal basis risk undermines the value of a hedge by reducing the number of end users that perceive the hedge as an effective tool for managing price risk. Lack of end users who perceive value in a hedge reduces the market for the hedge and its liquidity. We hope that the current work on Loss Rental Allocations and Financial Transmission Rights will lead final energy prices close to generation volume weighted costs (i.e. lower than the current consumption volume weighted costs) and minimal basis risk within ~ four zones across New Zealand.
- Hedges add to the prudential security burden; hedges need to be tightly integrated with the wholesale market to ensure they can be used by hedge purchasers to manage their prudential requirements. This means there needs to be a simple and automated mechanism for the Wholesale Electricity Market Clearing Manager to take account of hedge positions when calculating prudential exposure. The existing mechanism – Schedule H5 of the Rules does not work because it is not well integrated into the physical market. Under Schedule H5 participants jointly register a hedge with the Clearing Manager. The Clearing Manager then takes the hedge payments into account when calculating each participant's prudential exposure. A manager of a wholesale trading operation commented to us that he won't sign any schedule H5s because the transaction costs are just too high.

Features of a hedge market we would like to see

While we think EnergyHedge and ASX have been constructive first steps in the development of a hedge market – they have been just that – first steps with access limited to the major generator-retailers and a single bank.

As a next step we think it is essential to broaden access to the lower cost electricity that can be purchased through a combination of financial hedges with physical spot supply – especially as increased volatility drives up the cost of traditional fixed-price variable-volume (FPVV) contracts.

The requirement for broad access specifically excludes the development of a fully authorised futures market because the regulatory and capital adequacy requirements will restrict participation to just the major generator-retailers and banks.

In the context of New Zealand a reasonable next step means making hedges accessible to the many 1,000s of businesses that are using more than 1GWh of electricity per year – either directly or through market participants acting as brokers like Simply Energy. These end users currently have little choice but to buy FPVV electricity from generator-retailers and the generator-retailers have little incentive to offer low margin structured products to their customers when they are successfully selling high margin products.

In summary we would like to see:

- A single contract for market access and settlement
- Regulatory and prudential requirements that facilitate broad participation in the hedge market
- Prudential mechanisms that mitigate, rather than add to, the existing requirements through the wholesale physical market
- Products at multiple nodes consistent with the development of LRAs, FTRs or zonal pricing, and
- An evolving market that develops and supports a more diverse product range than base load swaps e.g. firming contracts, caps, residual contracts and a 10 year swap – with the priority on a product that provides a market consensus measure of volatility

We hope the industry will support the evolution of the hedge market in a structured and broadly inclusive manner, otherwise we may end up with a regulated solution that provides “a positive media story” for Government but does not address the needs of the industry and consumers.