



24 October 2006

Electricity Commission
PO Box 10041
Wellington
Attn: Jenny Walton

Dear Madam

Hedge Market Development – Issues and Options

MainPower appreciates the opportunity to contribute to the review of the future electricity hedge market as part of this review (“Review”). We do this from the position of a party that is prohibited from being involved in that market by reason of the Electricity Industry Reform Act 1998.

We firstly wish to acknowledge the submission provided by the Electricity Networks Association, and wish to note our support of that submission.

At the Christchurch briefing of the Advisory Group, those of us present were advised that the problems with the current market are;

1. Lack of robust and timely information
2. No hedge for location price risk
3. Lack of confidence in competitiveness
4. Weak understanding of price risks and how to manage
5. High participation and transaction costs

We would agree with the assessment as regards points 1 and 3-5. This is a result of the industry environment that has evolved in New Zealand. It is our view that these points are hugely inter-related – the lack of **liquidity and transparency** are the fundamental issues.

The Electricity Commission must be seeking outcomes that are likely to substantially improve the liquidity and transparency of the electricity hedge market. The Advisory Group’s recommendations do not achieve this – they are too minimalist in their effect. With liquidity and transparency, there is the best prospect of competition entering the market. EnergyHedge, for example, exists, but the volumes are so small and much of the non-price information months out of date, to suggest that the market is ineffective; it does not provide real liquidity or transparency.

Evidence of the need to encourage greater transparency and liquidity is obvious from the low levels of participation in industry forums of those other than industry participants directly affected by the rules. The absence of any serious users at the Working Group seminar is one small anecdotal example – in our dealings with consumers in the small to medium category, we find that they see the electricity market as too complex, costly, poorly understood and hence they do not involve themselves in it. That is an unfortunate outcome for the country and other consumers, but entirely understandable.

The challenge is how to create real liquidity and transparency in the highly vertically integrated industry that operates in this country? This is possible without requiring massive industry restructuring or changes to roles.

1. All generation – all hedging

At the most basic level we support the principle that markets operate most effectively if almost all activity flows through the market, in a transparent and efficient manner. This appears to be the case with respect to the physical electricity market.

However, it is our view that the associated hedge market does not conform to the same principles. Hence it is advisable to include all hedging activity within the scope of the market, and the underlying principles that assist markets to operate internationally for the benefit of market participants, and most especially the end-users of the product in question to be applied.

2. Genter internal activity

Substantially all of the potential hedge volume is not available to the market because the underlying energy flows between generation and retail arms of the vertically integrated gentailers. Hedges of these flows, and the associated terms, must be transacted through the hedge market if there is to be any hope of liquidity.

In practice this will require some form of internal separation (for reporting purposes) on the part of generator-retailers. It may also be essential to require each leg of these internal trades to be offered onto the market in their own right, to other participants, as a means of encouraging robustness in pricing.

3. Standardised Contracts

There is ample evidence internationally of the very favourable impact that standard terms and contracts have for improving the functioning (and liquidity and transparency) of markets. The model master agreement may well meet this objective – it is important that it is delivered within a short timeframe and then adopted by all participants.

4. Transmission Hedge

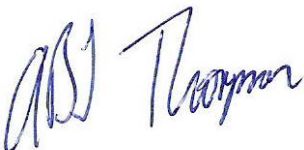
We refer to the ENA submission on this matter.

It is our belief that lines companies should be allowed to hedge, according to standard commercial principles, the output of generation that we are now permitted to own. Over time this would be another small and positive contributor to the efficiency and effectiveness of the electricity market. However, the EIRA absolutely prohibits this activity. It is our hope that the Electricity Commission will engage with the MED over this matter and seek to have the EIRA further modified to this end.

In short, the underlying physical and hedge markets are theoretically separate but conceptually linked; hedge participants will need to fall back onto physical arrangements (just as the reverse applies).

We would be pleased to participate further in the Review.

Yours sincerely



A B J Thompson
Business Development Manager