

SERVICE PROVIDER AGREEMENTS

Speech to the Gas Industry Company Annual Conference

11 August 2009

Thank you for inviting NZX to talk at your conference.

For those that don't know me – I head the strategy team at nzx – which looks 18 months to five years ahead in terms of thinking about new initiatives, business lines, the broader economic environment and where opportunities are, how to leverage of existing strengths into new markets. And how to get there.

I've thought quite a bit about what to talk about today. The topic I was given, service provider agreements, is vague enough that it gives me licence to talk about just about anything.

There are three key things that I'd like you to take away from the next few minutes:

1. NZX's strategy and values, and as part of this:
 - a. why we were delighted to acquire Mco
 - b. the opportunities that we see in this space, particularly through the Service Provider model
2. the infrastructure investment that NZX is undertaking and why

IMPORTANCE OF GAS TO NEW ZEALAND

The gas industry provides an important infrastructure for New Zealand - it underpins New Zealand economic performance in many ways.

Not just in terms of the **direct contribution to GDP** through output and job creation, skills and knowledge. but also as an input into industrial production and electricity generation.

And depending on which energy analyst you read, is generally considered to become more rather than less important over time.

New Zealand is one of only two countries in the OECD that does not have any international connections, either through pipelines or LPG re-liquefaction plants.

This makes domestically produced gas, and the methods by which it is transported and sold of vital importance, to the New Zealand economy and its performance. Efficient and transparent mechanisms in this sector, will have flow on impacts through out the economy.

In this, the two strategic objectives for the GIC for 2010 being efficient market operations and access to transparent markets make a lot of sense.

And as outsider, who has only had minimal interaction with the gas sector and its governance in the past, the progress of the GIC since its inception has been impressive.

I could list this, but suspect there would be little point for this audience, given your interaction with it on a much more frequent basis than i.

NZX'S CORE STRATEGY AND VALUES

In this context, I'd see NZX's values as well aligned with that of the GIC.

NZX and the capital market infrastructure that it provides is an important part of New Zealand's infrastructure and a key driver to growth. Just as gas is a key input to production - **capital markets provide a financing mechanism** that brings together borrowers and savers in a way to lower transaction costs, and enable **investment in growth producing assets**.

In fact, one of our key values (of which there are eight) is Advancing New Zealand.

STRATEGIC RATIONALE FOR PURCHASING M-CO

In this context, we see our acquisition of M-co fitting. We are enthusiastic to participate in markets that matter to New Zealand - and look to provide infrastructure and service provision that supports these markets to be efficient.

M-co provided us with this opportunity to extend our involvement in markets - and their ethos of 'liberating markets' was something that we saw as being a natural fit, from both a cultural and economic perspective.

It is fair to say however, that there was some bemusement in many quarters when it was announced that NZX was looking to acquire M-co.

In a manner very similar to NZX, M-co provided and provides market infrastructure that enables trading, settlement, price discovery and a wide range of information that goes into price setting.

Specifically, in gas they, and now we, are the allocation agent for the downstream reconciliation and allocation of gas, and the provision of the wholesale gas trading platform.

From NZX's perspective we valued the strong relationships that M-co had with GIC and EC as a service provider.

As part of this we value the partnership approach that is inherent in the Service Provider model. The Service Provider Agreements have very specific delivery requirements laid out, with delivery expectations and audit requirements.

The clarity of purpose and function in these agreements, combined with the close working relationships with the GIC and EC to develop industry solutions on an on-going and iterative basis was something we considered a strength of the model.

The Service Provider relationship is on-going - and provides the right incentives to the service provider to invest in the relationship, in knowledge acquisition and to actively seek out how to improve the market operations.

The clear expectations of the service provider agreements, combined with the ability and expectation to continue to modify and improve the system and delivery and ultimately the transparency of the industry fits well with the NZX ethos.

The acquisition provided the opportunity to develop liquid energy futures contracts. This may be some way off yet for gas. We recognise very much that this is something that needs to be done in partnership with the industry.

There would be no point to list products on a platform unless they were useful to the industry in some way - by helping them manage risk, reduce price exposure, provide certainty and therefore help with long term investment decisions and the like.

Third, the energy spot and futures markets will have strong links into **carbon** markets in the near future. NZX developed and has now sold the TZ1 carbon registry but remains interested in the potential for developing a carbon market. This will require some certainty around what an 'NZU' is and who has what obligations. But given the relationship between energy and carbon - we considered the potential for a combination of these two products to provide greater risk management tools for New Zealand industry.

The knowledge that is now increasingly resident in the extended NZX group, provides us with a much stronger position from which to continue to consider options for both domestic and international opportunities that leverages off our existing strengths. This provides us with the scale and scope to do things we are not yet aware of.

SPECIFIC OPPORTUNITIES

One area that is a key focus for NZX is providing data to support trading and market development. Our belief is that data, information and analysis builds transparency in a market and encourages trading, efficient price setting and improved outcomes for the underlying industry as a result.

We have set up an indices team that sits as part of the strategy team to look at what data and in what form would be useful to market participants. How can we usefully add transparency to markets, if you like. The focus for the

team is across the range of markets that NZX is involved in including securities, debt, agri and energy.

Gas in an area that we, both NZX and M-co, are still new to, so if there are any obvious gaps we could help with, do let us know.

Gas is different

Something that we are acutely aware of - is that the gas industry is a different to other industries and products that NZX is currently operating in.

For NZX it is a learning curve to for us to understand these markets, and their key characteristics.

And in my view this is a very important thing for NZX to do, to be able to ensure that we can learn from them, and they from us to build a better offering to our now much broader range of customers.

In the vein of sharing learning to improve overall outcomes, i'd like to spend a couple of minutes providing a quick sketch of some important infrastructure investment that NZX is currently undertaking.

While initially it will be of primary benefit for equity markets, the investment will provide opportunities for a range of markets in New Zealand.

New Zealand Clearing Corp

NZX is setting up a clearing house and CSD or central securities depository.

This may all sound like jargon - but essentially it is about bringing up to international standard all the systems and processes that kick in after a trade is made. it is the processes around ensuring that the buyer gets their product, be it CEN stock, ANZ bonds, and the seller gets the cash that they are entitled to.

One of the biggest surprises to me in moving to NZX, was just how complex this is.

The key functions of the clearing house will be to sit in the middle of a transaction. it will become the buyer to the seller and the seller to the buyer. or the jargon term is become a central counterparty.

Then each buyer and each sellers' obligations are with the central counterparty and not with whoever was on the other side of the trade.

This may sound a bit like technical tidying - but what is exciting is the opportunities that it provides for markets.

By having a clearing house or central counter party:

- reduces counter party risk: in a situation where there is anonymous trading, and no clearing house, a market participant is taking settlement risk on someone that they don't know who they are. this is eliminated - as it allows participants to easily assess the counterparty risk of a single institution that is prudentially and otherwise regulated by a key central government agency.
- netting: instead of having to settle each trade individually as they are with a range of different participants - a clearing house enables all the buys and all the sells to be netted off against each other. In Europe, this reduced the amount of capital required for settlement by 90% on average.
- Reduced systemic risk, and reduced risk of 'spillover'. The clearing house standing in the middle of all trades will reduce the chance of any systemic contagion occurring from any single participant default. That is, one participant's ability to meet its settlement obligations is no longer dependent on receiving delivery or stock or cash from another participant - as the clearing house is now managing this.

- Enhanced settlement assurance - Settlement finality. This will ensure that transactions are irrevocable and are not subject to general insolvency laws. This protection does not exist with the current FASTER settlement function or Austraclear, as any settlement monies or script could potentially be clawed back by receivers if a market participant entered liquidation.

Finally, the technology of the Clearing House will enable derivatives or futures products to be traded.

The present settlement system only supports cash products and very vanilla transactions. However, the major product growth opportunities are in commodities and options. I've discussed this earlier - but New Zealand is one of a very few markets internationally that currently does not have any domestic futures market.

Conclusion:

The gas industry and the gas market has undergone considerable change over the past ten years. The changes that have occurred have spanned access to pipelines, balancing, registry creation and even the potential for wholesale gas trading on a platform.

We're keen to continue the excellent work begun by M-co in terms of building market place infrastructure and providing transparency and systems that support industry participants in their business and supporting the GIC in their strategic priorities of improving market efficiency.

It is great to have them on board, in our office and we are very much looking forward to them being able to continue this, and provide a broader service to gas industry participants through the backing of nzx and wider range of technology infrastructure and information available for solution development.

In terms of service provider agreements themselves from our perspective we see the merger as a positive:

- NZX is very committed to ensuring continuing high quality customer service to the GIC, and industry participants. NZX was attracted to M-co because of its reputation here - and it is important that this is maintained
- the partnership approach of the Service Provider Agreements given their timeframe and the desire of GIC and EC to improve the market operations is a model we strongly support. It provides a certain base from which to work from.
- the backing of NZX, as a larger firm, will also provide greater resources to be able to be pulled into a project and ensure delivery.

NZX has a short list of values that it aims to live by. Two key ones are accountable, and advancing New Zealand. Given the vital infrastructure role that gas plays for New Zealand's economic performance, I suspect they are also relevant for your industry.

I personally look forward to the challenge of learning more about the gas industry and considering in what way we can help the industry and the GIC continue to improve the functioning of the market.

Thank you