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Submitted online to: <https://www.aemc.gov.au/rule-changes/market-making-arrangements-nem>

Dear Mr Pendlebury,

Market Making Arrangements in the NEM
Reference: ERC0249

The Australian Energy Council (the “**Energy Council**”) welcomes the opportunity to make a submission in response to the Australian Energy Market Commission’s (“**AEMC**’s”) *Market Making Arrangements in the NEM Consultation Paper*, and appreciates the extra consultation time and rigour in the AEMC conducting this process.

The Energy Council is the industry body representing 23 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia, sell gas and electricity to over ten million homes and businesses, and are major investors in renewable energy generation.

Introduction

The dynamic nature of the half-hour to half-hour price changes in the National Electricity Market (“**NEM**”) and breadth of possible price variations between the market price cap and the market floor price mean that market participants are reluctant to accept price exposure, and seek arrangements to mitigate their risks to the extent necessary to satisfy their internal risk management policies and broader corporate risk appetite. One of the means to mitigate these risks is to engage in the contract market, which provides a mechanism by which companies can use financial derivatives to counter the volatility of the wholesale electricity market.

Unquestionably the efficiency and liquidity of many financial markets are benefited by the presence of market-makers. Typically market-makers emerge organically, either through the unilateral action of a major participant, or by a mutually beneficial commercial arrangement between major participants and an exchange. The Energy Council considers this the preferred way for market-making to emerge where it is useful, and notes attempts underway by ASX Energy to develop such an arrangement.¹

While market-making is clearly very useful in some markets, this should not be interpreted to mean that a market without such activity is necessarily lacking. Obscure markets to which very few participants are exposed are unlikely to ever have sufficiently broad interest to justify the cost and effort of forming a market-making function. The absence of organically developed market-making is likely to be simply a symptom of these characteristics. Artificially introducing market-making into such a market is not going to change these characteristics.

In the Australian Competition and Consumer Commission’s (“**ACCC**’s”) Retail Electricity Pricing Inquiry,² it was recommended that, “The AEMC should introduce market making obligations in South Australia, which require large, vertically integrated retailers to make offers to buy and sell specified hedge contracts each day, in order

¹ See https://www.asxenergy.com.au/newsroom/industry_news/market-making-expressions-of-

² Australian Competition & Consumer Commission, *Restoring electricity affordability and Australia’s competitive advantage: Retail Electricity Pricing Inquiry – Final Report*, June 2018

to boost hedge market activity”.³ Thus, unwilling participants would be obliged to market-make. This has also been the focus of the Energy Security Board (“**ESB**”) in its September 2018 Consultation Paper.⁴

The Engie proposal, the subject of the AEMC’s Consultation Paper, differs from the ACCC and ESB proposals by suggesting a voluntary market-making mechanism, which would be overseen by the Australian Energy Regulator (“**AER**”). While it is not immediately apparent that any market-making mechanism is required to be centrally facilitated, to the Energy Council’s mind a voluntary mechanism reduces the market distortions inherent in a mandatory mechanism, maintains the underlying free market philosophy of the NEM’s design, and provides the flexibility for buyer and sellers to participate to the extent of their individual ambitions. In those respects it is considered superior to the ESB’s Market Liquidity Obligation proposal.

Discussion

Market-making mechanisms are a means by which perceived lack of liquidity in markets can be addressed by either having willing participants (in the case of a voluntary scheme) or obligated participants (in the case of mandatory scheme) bid to buy contracts or offer to sell contracts. In each case the changes in the market design will result in market effects (short-term and long-term), and it is necessary for the positive and negative market effects to be assessed to determine whether the scheme will achieve its intended outcome, and the benefit of the outcome will outweigh the cost of achieving it.

The mitigation of some of the possible deleterious effects can be assisted by introducing measures such as delaying the requirement for market-makers to refresh their quotations once an offer has been accepted, and limiting the number and volume of offers needed to be made available to the market. The Energy Council supports limitations such as these, and recommends that any design ensure that unduly onerous obligations are avoided.

While it is important that the scheme not be compulsory (for example as some parties may have difficulties in managing their underlying fuel supplies to provide the necessary products), it is also important for all possible (and interested) parties to have the opportunity to participate in the scheme. The Energy Council therefore recommends that any scheme be made available to all interested market participants to ensure that it is not limited to companies backed by physical generation, and that any design provides a framework by which contracting parties can sub-contract their arrangements, if desired, to foster innovation.

Nevertheless introduction of the scheme will, by practical necessity, be limited in the type and volume of products which will be made available. Standardising products in this way may nominally increase liquidity, but at the cost of stifling innovation. This is another reason why organically developed market-making, such as that being explored by ASX Energy, is more likely to be consistent with the needs of participants, and therefore more likely to be successful, than one designed by disinterested external parties. The Energy Council suggests that the AEMC considers whether, after an initial period of limited products to test the market, a future market-making mechanism be introduced which can allow flexibility in the definition of products to allow alternatives to qualify and meet the needs of the parties better.

Finally, introduction of additional compliance obligations (whether mandatory or voluntary) is never without cost. *Prima facie* there will be administration costs to be incurred by the AER and those participating in the scheme, but there may also be costs associated with the changes in market conditions, particularly if the obligation is mandated. For example, if participants are forced to enter into trades with smaller counterparties with lower credit ratings and no credit risk premium, the additional risk will need to be transferred to the participants’ other counterparties, with a consequent increase in costs for them. This results in inequitable treatment of counterparties, with the effect that those counterparties with a higher credit rating will subsidise the lower credit rating counterparties. It may also impinge upon organisational risk management policies (such as counterparty concentration), and call into question directors’ proper discharge of their duties.

The Energy Council notes that ASX Energy is seeking to establish a voluntary market-making scheme. This may address many of the perceived needs for such products and has the advantage of the parties to the scheme being competent and willing. The market is intended to be established from 1st April 2019, and on this basis the Energy Council suggests that a prudent course of action would be to delay the rule consideration process to assess the outcomes from the introduction of ASX Energy’s voluntary scheme.

³ Recommendation 7

⁴ Energy Security Board, *Market Making Requirements in the NEM Consultation Paper*, September 2018

In addition, the Energy Council is concerned that any need for the proposed rule change is transitory and likely to be materially affected by the regulatory, technical and commercial evolution of the market. Significant market changes are either in train, such as Five Minute Settlement (which will commence on 1st July 2021), or proposed, such as the implementation of dynamic regional pricing from July 2022.⁵

Conclusion

In conclusion, the Energy Council believes that with the power system in regulatory and commercial transition, and the introduction of the ASX Energy's voluntary scheme imminent, the consideration of market-making as proposed by the consultation paper should be delayed. Once the need for market-making becomes clearer, the AEMC should favour a voluntary scheme, with significant flexibility to encompass innovative products and enthusiastic parties. In addition, the costs and benefits of such a voluntary scheme need careful consideration to ensure that the expected outcomes will meet the National Electricity Objective.

Any questions about this submission should be addressed to the writer, by e-mail to Duncan.MacKinnon@energycouncil.com.au or by telephone on (03) 9205 3103.

Yours sincerely,



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⁵ Australian Energy Market Commission, *Coordination of Generation and Transmission Investment Final Report*, 21st December 2018