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Thursday, 7 February 2019

Russell Pendlebury  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Dear Mr Pendlebury

**RE: Market Making Arrangements in the NEM (ERC 0249)**

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC) consultation paper on the market making arrangements in the National Electricity Market (NEM) rule change request.

**About ERM Power**

ERM Power is an Australian energy company operating electricity sales, generation and energy solutions businesses. The Company has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load<sup>1</sup>, with operations in every state and the Australian Capital Territory. A growing range of energy solutions products and services are being delivered, including lighting and energy efficiency software and data analytics, to the Company's existing and new customer base. The Company operates 662 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland.  
[www.ermpower.com.au](http://www.ermpower.com.au)

**General Comments**

Contract market liquidity is central to the smooth functioning of both retail and wholesale markets. Entering into financial contracts helps to bring more certainty to revenues and costs for generators and retailers respectively. A deep and liquid contract market supports retail competition and therefore contributes to improved customer outcomes.

The past few years has seen a decline in contract market liquidity, and while there is no single factor or party to blame, the consequences of a continued decline in liquidity may start to impact prices and competition in the market. ERM Power considers it important to investigate ways to improve contract market liquidity and market making arrangements are the best way to achieve this. The Australian Competition and Consumer Commission's (ACCC) final report into electricity prices recognised this as an issue and recommend market making requirements as a solution.

The risks of further declines in liquidity may be exacerbated if the Retailer Reliability Obligation (RRO) is implemented and triggered. Under the RRO, retailers will be required to demonstrate that they have firm contracts to cover their demand during a one-in-two year peak. While retailers *must* contract under the RRO, generators *may* contract, leading to significant risks for parties who are unable to procure sufficient volumes of contracts. ERM Power has consistently argued that because of this, market making requirements like those proposed under the

<sup>1</sup> Based on ERM Power analysis of latest published financial information.



Market Liquidity Obligation (MLO) are necessary to ensure that smaller retailers are not pushed into non-compliance.

We consider that the optimal approach is one that is tied to contract market liquidity and that applies to the largest vertically-integrated parties in each region – consistent with recommendation 7 of the ACCC’s final report into electricity prices<sup>2</sup> – rather than ENGIE’s proposed model of a permanent, customer-funded tender to provide services. Our model is similar to the MLO proposed by the Energy Security Board (ESB) and the market making arrangements proposed by the ACCC. Importantly, our proposed model, and in fact each of the various market making arrangements, would require market makers to post a bid and an offer. This allows parties with an obligation the opportunity to both buy and sell at a level commensurate with the underlying market fundamentals.

ERM Power considers that the rule change proposal is inferior to other models proposed by the ESB and ACCC. Should the AEMC make this rule change, we encourage it to implement market making arrangements similar to the model we propose in this submission.

### **Liquidity problems**

Contract market liquidity is central to the smooth functioning of both retail and wholesale markets. Generators, retailers, large users and financial intermediaries enter into financial contracts to bring more certainty to revenues and costs for generators and electricity users. Hedging contracts provide parties with a risk management tool and enable price discovery. A deep and liquid contract market supports retail competition by allowing various parties to manage the risks of volatility in the spot price without having to own their own generators. This all helps to improve outcomes for customers through more secure prices, and greater choice in the retail market.

The past few years has seen a decline in contract market liquidity, and while no single factor or party is solely responsible, the changing dynamics in the market – vertical integration, generator concentration, increased variable renewable generation, gas availability and cost – means the consequences of further declines in liquidity may start to impact prices and competition in the market. The ACCC’s final report into electricity prices provides evidence that indicates that while there is generally sufficient contract market liquidity in the NEM, problems exist in South Australia and appear to be nearing low levels in NSW. ERM Power considers that at this stage, market making arrangements are the best way improve contract market liquidity.

In time, alternative risk management tools such as the use of demand response or aggregated battery storage may become available and economical for small participants and new entrants. However, in the present environment, we consider the contract market represents the simplest and most effective risk management tool available to market participants. Given this, it is important that small participants not be locked out of markets due to a lack of contract market liquidity. As such, market making arrangements imposed on large vertically-integrated gentailers, in line with the ACCC’s recommendation 7, represent the best tool available to enhance contract market liquidity in regions where there is a problem.

### **Range of options and proposed solution**

ERM Power acknowledges the design of the rule change request as a tender process and the need for the AEMC to assess the rule change on this basis. However, we contend that a version of the AEMC’s suggested Option 3 for market making – a trigger-driven obligation – will ultimately be more beneficial to customers and small market participants as a whole.

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<sup>2</sup> ACCC, Restoring electricity affordability & Australia’s competitive advantage: Retail Electricity Pricing Inquiry, June 2018, p 130.



We consider market making arrangements should be imposed on large, vertically-integrated gentailers when contract market liquidity drops below a threshold level. In our view, this threshold should be set at 1.5 times underlying demand in a region. This represents a level of trading that demonstrates a sufficiently liquid contract market that provides ample opportunity for both buyers and sellers to manage their contract positions. This should exclude 'exchange for physical' (EFP) trades where existing OTC contracts are converted into exchange traded products. EFP trades can appear at first glance to look like increased liquidity but in fact do not represent such. Below this level, we believe that action in the form of market making requirements is needed to improve liquidity

Additionally, we consider that care has to be taken to avoid a situation where the requirement drops in and out or leads to a contracting 'cliff' where liquidity suddenly drops. For this reason, we believe that the requirements should apply for two years from the quarter to following initiation on a rolling basis. That is, as long as underlying liquidity in a NEM region remains below the trigger level – 1.5 times underlying quarterly consumption – there should be a two year forward window where market making obligations apply. This would mean that the obligation would not end until there had been two years of trading with levels above the trigger point. Participants with a generation market share in the relevant region of 15 per cent or greater and the possession of a retail licence should be covered by the obligation. This is based on one of the options suggested by the ESB in its consultation on the implementation of the ACCC's recommendation 7.<sup>3</sup>

We believe that this is a superior model to the proposed rule change. The market making arrangements under the proposed rule change would apply in all regions at all times regardless of whether there is a problem with liquidity or not. Given that the proposed model also would recoup costs from consumers, this creates a situation where customers may be paying for a requirement that is not needed. In situations where there is a genuine liquidity problem, it would also lead to one party providing the service rather than a range of parties as would be covered under our proposed model.

The proponent argues that an obligation to provide hedges may reduce the overall level of risk products available in the market and that market making obligations may not help smaller retailers who favour tailored arrangements. ERM Power strongly disputes this claim. It is true that small participants may seek tailored arrangements such as load-following hedges to manage their risks. However, large participants who would be covered by a market making obligation are not the only ones able to offer such products. Increases in underlying liquidity will enable other parties such as independent retailers and financial institutions to access contracts, and therefore offer risk management products such as load-following hedges. For example, ERM Power, as a commercial and industrial retailer, essentially offers load-following hedges to its customers. We then manage risks at the margins for changes in our customers' consumption.

Without the ability to access hedges, we and other parties are unable to aggressively compete in a market. In contrast to the proponent's claims, we believe that market making arrangements will in fact enhance competition for risk management products, thereby supporting retail market competition.

### **Range of products**

Obligated parties should be required to make a relatively simple suite of products available to meet this requirement: flat swaps, peak swaps, and caps. We believe this provides a workable balance between ensuring contracts are made available as soon as possible, while allowing obligated parties time to adjust to having to make contracts available.

ERM Power recommends that obligated parties should be required to post 5 MW parcels as part of market making requirements, but that other parties should be able to purchase in increments of 1 MW. By allowing parties to purchase in increments of 1 MW, small participants and new entrants will be able to access smaller parcels more appropriate for their load size. This should, by extension, support retail competition.

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<sup>3</sup> Energy Security Board, Market Making Requirements in the NEM Consultation Paper – September 2018.



These products should be made available during the last half hour of the trading day. Additionally, obligated parties should only be required to buy or sell 5 MW net in any quarter each day. That is, if their offer is accepted, their bid can remain in place without needing to post another offer. If the bid is then accepted, the obligated party would have essentially returned to their starting point and a new bid and a new offer should then be posted. This would help to keep the requirement somewhat limited in terms of net impact on the participant.

In the ESB's consultation on market making requirements, a bid-offer spread of 5 per cent was flagged. Given the current state of the market, we believe that this may in fact be too large in some cases and too small in others. Instead, a more nuanced approach is necessary depending on the product. By way of example, flat swaps for Q1 2019 in Victoria are trading around the \$130 mark (as of 22 January 2019). A 5 per cent spread represents a \$6.50 spread. For peak swaps, the spread would be even higher in dollar terms based on current contract prices.

As such, we consider that the following approach should be taken depending on contract type:

- Flat swaps: the lesser of 5 per cent or \$2/MWh.
- Peak swaps: the lesser of 5 per cent or \$5/MWh
- Caps: 15 per cent.

We propose a higher spread for caps due to the fact that these are generally lower priced products and therefore a wider spread is likely to have a lower impact in dollar terms.

ERM Power considers that the market already understands who the large vertically-integrated retailers are, and that the most transparent test is the possession of a retail licence and having generation registered with AEMO. However, we are not privy to the exact nature of every party's corporate structure to adequately understand whether this would in fact capture all vertically-integrated retailers.

A 15 per cent generation share in a market provides the most suitable basis for imposing the requirements. These will certainly be large generators with the capability to make liquidity available if need be.

Thresholds for generator market share should be based on the registered capacity of scheduled generation. Considering methods such as the bidding of available capacity through AEMO's Projected Assessment of System Adequacy (PASA) process could lead to gaming where generators bid as unavailable to avoid obligations but then make capacity available at short notice.

We do not consider that retailer size threshold is necessary. It may in fact be counter-productive as a threshold expressed in terms of customer numbers or market share of load could provide an incentive to limit customer numbers and thereby avoid the obligation. This runs the risk of reducing retail competition in markets that may already have a lower level of competition. To the extent that a gentailer would seek to limit customer numbers or load, we would expect this to be at a very marginal level unlikely to benefit small retailers.

In the event that the RRO is implemented and a gap period declared, a different approach is needed. In this scenario, we believe that market making arrangements should only apply for the specific gap period commencing when the gap period has been declared at T-3 years. This is similar to what was proposed as part of the Market Liquidity Obligation. If there is already a making-making provision in place due to liquidity reasons, we consider that it should take precedence, and that there is no need to implement a second requirement for the gap period.

### **Jurisdictional specific issues**

The consultation paper asks about which regions in the NEM are there liquidity issues and in which market making arrangements should apply. Our proposed model is intended to operate in any region of the NEM (with a limited exception in Tasmania) if the trigger level is breached. This is consistent with the rule change request which proposed a tender in all regions at all times. At present, we would expect that market making arrangements would be imposed in South Australia immediately.



The rule change proponent argues that the specific dynamics in South Australia, in particular the high penetration of intermittent renewables and the reliance on gas-fired generation makes imposing an obligation in South Australia risky for those participants. Market making obligations like those proposed by the ACCC, the ESB and even the rule change proponent do not limit market makers to selling contract. The market making requirements in all these versions require a bid and offer within a limited spread. To the extent that a market maker in South Australia sees that contract prices are below that which would be economic based on gas prices, they would be able to bid at a level that allows them to purchase contracts. The market maker can therefore benefit from their status as a market maker. Eventually, it would be expected that the market would strike a balance at an efficient level that allows those with an obligation to sell contracts at an economic level based on current input prices, such as gas and the associated transport costs.

Furthermore, ERM Power believes that the AEMC needs to look at market making at a NEM-wide level. A solution that suits all regions of the NEM is necessary rather than focusing on South Australia alone.

Finally, in Tasmania there are already state government-imposed requirements for Hydro Tasmania to make contracts available to those seeking them. Provided that these remain in place, ERM Power does not believe that market making requirements are needed in Tasmania.

## **Conclusion**

Contract market liquidity is central to the smooth functioning of both retail and wholesale markets. Entering into financial contracts helps to bring more certainty to revenues and costs for generators and retailers respectively. A deep and liquid contract market supports retail competition and therefore contributes to improved customer outcomes.

The current contract market in South Australia warrants intervention to ensure that contracts are available to allow small participants to compete in the market. A solution that can apply to any region where the contract market is illiquid is therefore necessary. ERM Power does not support the proposed rule change and instead, we encourage the AEMC to make a more preferable rule change based on our proposed design. We believe that our trigger-based solution would more effectively enhance transparency and competition in the wholesale and retail markets without imposing direct costs on consumers.

Please contact me if you would like to discuss this submission further.

Yours sincerely,

[signed]

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