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**EnergyAustralia**

LIGHT THE WAY

Mr John Pierce  
Mr Charles Poppel  
Ms Michelle Shepherd  
Dr Brian Spalding  
Ms Allison Warburton  
Australian Energy Market Commission  
PO Box A2449  
SYDNEY SOUTH NSW 1235

EnergyAustralia Pty Ltd  
ABN 99 086 014 968

Level 33  
385 Bourke Street  
Melbourne Victoria 3000

Phone +61 3 8628 1000  
Facsimile +61 3 8628 1050

enq@energyaustralia.com.au  
energyaustralia.com.au

Lodged electronically: [www.aemc.gov.au](http://www.aemc.gov.au) (ERC0249)

Dear Commissioners,

### **AEMC 2019, Market making arrangements in the NEM**

We welcome the opportunity to comment on the AEMC's consultation paper on ENGIE's rule change request, Market making arrangements in the NEM. EnergyAustralia is one of Australia's largest energy companies with around 2.6 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. We also own, operate and contract an energy generation portfolio across Australia, including coal, gas, battery storage, demand response, solar and wind assets with control of over 4,500MW of generation in the National Electricity Market (NEM).

We are generally supportive of ENGIE's rule change proposal that would require the Australian Energy Regulator (AER) to operate "a tender for market making responsibilities in the NEM". There continues to be no justification for any compulsory market making obligation in the NEM as it enjoys fairly high levels of liquidity in all regions, with the exception of South Australia which faces a number of structural issues inhibiting greater liquidity. As an alternative approach, a tender would provide a mechanism in which market making obligations could be provided by parties (not confined to physical participants) who not only have the expertise to participate in the obligation but also the appetite to manage the associated risk.

In considering this rule change request we encourage the AEMC to take a holistic assessment of the various proposed interventions on the electricity contract market, including the Treasury Laws Amendment Bill<sup>1</sup> and the Market Liquidity Obligation (MLO) proposed by the Energy Security Board (ESB)<sup>2</sup>. These proposed interventions will increase the costs and risks for participants to operate in the electricity contract market, to this end the AEMC should ensure that the benefits to customers outweigh the costs and will lower prices in the long term.

EnergyAustralia considers that a tender for market making responsibilities in the NEM is far superior than the MLO currently proposed by the ESB. Furthermore, if an alternate market making arrangement (such as the one proposed by ENGIE) is already operating

<sup>1</sup> [https://www.aph.gov.au/Parliamentary\\_Business/Bills\\_Legislation/Bills\\_Search\\_Results/Result?bid=r6256](https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bid=r6256)

<sup>2</sup> <http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/Market%20Making%20Requirements%20in%20the%20NEM%20Consultation%20Paper.pdf>

in a NEM region then there should be no need for an MLO to be enforced as well. We therefore encourage the AEMC to consider the interaction of this rule change request and the ESB's, and recommend this tender process be integrated into the Reliability Obligation instead of the proposed MLO.

The ASX is also currently looking to introduce voluntary market making in the Australian Electricity Futures, Caps and Options contracts market<sup>3</sup>. We consider that the tender for market making responsibilities in the NEM (as proposed in the paper) is not dissimilar to the ASX scheme with the key difference being the additional incentives to participants to make markets under the tender. This may incentivise additional parties over and above physical participants (financial intermediaries for example) to participate in market making arrangements, thereby improving liquidity.

Any market making obligation should not act in a way that forces additional risk on parties that are either unwilling to take this risk (for example due to internal risk limits) or are unable to effectively manage this additional risk. Mandating compulsory market making on physical participants is unlikely to create additional contracts and may reduce current levels of liquidity across the trading day, focussing liquidity within the compulsory trading window.

### **Market making examples in other regions**

EnergyAustralia remains concerned about the effectiveness of market making arrangements in general. Based on evidence from overseas energy markets, we are not convinced that compulsory market making is in the best interests of the customer. Numerous other jurisdictions have trialled various forms of market making with mixed results in the efficiency and effectiveness of the schemes. For example:

- in New Zealand, the regulator is considering the effectiveness of the scheme after market maker spreads widened during a period of tight supply<sup>4</sup>.
- likewise, in the United Kingdom, The Office of Gas and Electricity Markets (Ofgem) has just reviewed aspects of their market making scheme after market makers complained of financial losses, disproportionate costs and credit risk<sup>5</sup>. Ofgem has indicated that it is likely the scheme will be suspended early in 2019<sup>6</sup>.
- in Singapore, market makers are paid to market make under a voluntary scheme<sup>7</sup>. The Energy Market Authority (EMA) has recently extended the scheme to July 2021 however a recent review highlighted that the EMA is continuing to monitor the actual benefits of the scheme to customers<sup>8</sup>.

These examples suggest that the theoretical benefits of market making requirements are difficult to achieve, and that if not implemented effectively the measures are likely to create more problems than they seek to solve. In this light, an underlying futures

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<sup>3</sup> [https://www.asxenergy.com.au/newsroom/industry\\_news/market-making-expressions-of-](https://www.asxenergy.com.au/newsroom/industry_news/market-making-expressions-of-)

<sup>4</sup> <https://www.ea.govt.nz/dmsdocument/23548-2017-winter-reviewhttps://www.ea.govt.nz/dmsdocument/23548-2017-winter-review>

<sup>5</sup> [https://www.ofgem.gov.uk/system/files/docs/2017/12/december\\_2017\\_consultation\\_final.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/12/december_2017_consultation_final.pdf)

<sup>6</sup> [https://www.ofgem.gov.uk/system/files/docs/2018/11/november\\_2018\\_update\\_secure\\_and\\_promote\\_1.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/11/november_2018_update_secure_and_promote_1.pdf)

<sup>7</sup> The Singapore scheme is similar to the proposed voluntary tender process by ENGIE

<sup>8</sup> <https://www.ema.gov.sg/cmsmedia/Consultations/Electricity/2018/PD/Electricity%20Futures%20Market%20Final%20Determination%20Paper%20vf.pdf>

market liquidity problem needs to be clearly established prior to any compulsory market making requirements being imposed.

### **Challenges with compulsory market making**

As the results of market making arrangements from other jurisdictions indicate, there are numerous challenges and risks associated with market making, particularly if the mechanism is compulsory and imposed upon physical participants. For example:

- specifying the prices of contracts may require obligated parties to make markets at a loss or at a price that is unviable for their assets over the long term. Forcing this behaviour could expedite temporary or permanent closures of generators.
- requiring a market making window tends to concentrate liquidity into that period, reducing liquidity across other periods in the trading day.
- challenges around identifying the benefits from market making. Customers that need access to financial contracts may not actually see any benefit as more sophisticated financial market participants may "soak up" liquidity in the trading window.
- compulsory market making has the potential to increase an obligated party's exposure to lower credit quality counterparties inconsistent with its internal risk framework.
- Standard products such as swaps and caps are relatively blunt instruments for small retailers, and minimum trade sizes (e.g. 1 or 5MW) are unlikely to be small enough to solve some of the issues they face.

### **South Australia specific issues**

While we recognise there are challenges in obtaining/selling contracts in South Australia for both customers and generators at the granularity/price that is preferred, this does not necessarily indicate a failure of market liquidity. Rather there are a number of specific issues driving this, including:

- The relatively small size of the market and the fact that South Australia's physical spot market is very volatile and highly sensitive to weather patterns and single asset contingencies.
- There is low accountability of the Transmission Network Service Provider (TNSP) for market impacts when scheduling transmission outages and associated interconnector constraints, substantially increasing the risk of selling contracts from outside the region.
- There is frequent and material market intervention by the system operator which both distorts market prices and dramatically increases the risk of offering financial products.
- Heavy reliance on gas powered generation which has both high variable (fuel) and high fixed (transport) costs.

These factors all contribute to the lack of contract liquidity in South Australia and the enforcement of compulsory market making arrangements will not solve these structural problems.

### **Proposed tender process**

We are supportive of the high-level design of the tender process for market making proposed by ENGIE. As is identified in the rule change proposal a voluntary tender process for market making resolves many of the issues stemming from compulsory market making. Consistent with the National Electricity Objective (NEO) the process would:

- ensure market making services that are provided outside normal financial market operation are transparent, fairly valued and the cost recovery of these services is appropriate.
- encourage additional parties to participate in market making that might be better suited to perform this role, outside purely physical participants.
- allow each market maker to offer contracts that suit their underlying portfolios and risk appetites.
- minimise the potentially significant risks inherent with obliging participants to offer contracts over and above their internal risk limits and appetite.
- not undermine market and investment signals by avoiding placing further risk premiums on investment in a specific region or all regions to account for unmanageable risk and costs.

Through the rule change process, the AEMC should give consideration to what is an efficient outcome from market making arrangements versus the actual cost of the tender. Further work should be completed by the AEMC to understand the likely benefits and associated cost to customers.

The tender should be conducted on a shorter timeframe than is proposed in the rule change request, a period of 1-2 years should be used. Further the AER should run a separate tender for each region (each node) in the NEM with the cost of engaging the tenderer being recovered from market customers in that region<sup>9</sup>. This ensures that customers who benefit from the market making also fund the costs to provide it.

Consideration needs to be given to how market making would occur on either established or non-established platforms and the impact on competition for this service. Over the counter (OTC) contracts should also be eligible to satisfy any market making obligations. In this case there may be some reporting requirements on the market maker (for example to the AER) to review that obligations are being met.

The rules should empower the AEMC/AER to create guidelines (through a consultation process) around what is expected from the successful tenderer around volume, prices, spread, daily requirements and limits, desired trading window and any 'break glass'

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<sup>9</sup> In this regard the tender would operate in a similar manner as to the Singapore model, where the fee to engage the market maker is recovered from customers.

events that would require suspension/pausing of the market making requirements. For example, a participant being completely exposed to an obligation to make a market if material changes to their portfolio occur due to a significant plant or fuel issue, or market events and information that are likely to distort the financial market outcomes. The AEMC and AER should give consideration to how onerous or prescriptive the guidelines would be and the impact that this may have on the cost of engaging the market maker. Each tenderer can then propose market making arrangements (that satisfy the high-level design of the obligation) that suit their preferred risk appetite and position in the market.

There should be penalties for non-performance of the agreed obligations under the tender process. The market maker should be penalised on an increasing scale of non-performance. EnergyAustralia considers that there should be a review of market making arrangements before the next tender process is run to examine the costs to and benefits received by the customer.

## **Conclusion**

EnergyAustralia is supportive of a voluntary tender process for market making in the NEM and believes that this is a far superior mechanism than the compulsory MLO proposed by the ESB. We recommend this voluntary tender process be integrated into the Reliability Obligation instead of the proposed MLO. If a formalised market making process (such as an AER tender) is already occurring in a region then there should be no need for an MLO to be enforced in that region as well.

We do not consider that there has been sufficient justification for a requirement to enforce compulsory market making in the NEM or that the benefits to customers outweigh the risks to the market. Examples in other jurisdictions have further highlighted the risks and challenges associated with any compulsory market making obligations.

A voluntary tender for market making would ensure participants are not forced take on risks beyond their ability and/or appetite to manage these risks, and likely incentivise additional parties to participate in any arrangement, for example financial intermediaries. Further, the proposed tender process would fairly allocate any associated costs of the market making arrangements to those who stand to benefit most from it.

If you would like to discuss this submission, please contact Andrew Godfrey on 03 8628 1630 or [Andrew.Godfrey@energyaustralia.com.au](mailto:Andrew.Godfrey@energyaustralia.com.au).

Regards

**Sarah Ogilvie**

Industry Regulation Leader