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Australian Energy Market Commission
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Market making arrangements in the NEM Consultation paper

Snowy Hydro Limited welcomes the opportunity to comment on matters raised in the Consultation Paper from the Australian Energy Market Commission (the Commission) on the Market making arrangements in the NEM.

Snowy Hydro Limited is a producer, supplier, trader and retailer of energy in the National Electricity Market ('NEM') and a leading provider of risk management financial hedge contracts.

Executive Summary

Snowy Hydro exerts that market liquidity in the contract exchanges and the Over the Counter (OTC) contracts are already sufficiently liquid. Hence, we firmly disagree that there exists any material issue/problem that warrants the need to set up a market making function in the NEM. The issue of price and availability of financial contracts should be properly analysed by the Commission. Anecdotal evidence suggests contracts of all forms are available especially if they are negotiated well ahead of real time dispatch.

The price of these contracts may not be able to be matched/agreed between Sellers and Buyers. This issue becomes more acute the closer to real time dispatch. This is a conscious choice made by both the Seller and Buyer not to transact. There are consequences for both Sellers and Buyers with this choice to effectively go to the Spot market. If eventual Spot prices are low then the Buyer is vindicated at the expense of the Seller. The converse is true if the eventual Spot price turns out to be high. This a dynamic that plays out in the market and a function of the risk tolerance of players. Therefore, Snowy Hydro's clear position it that there is no need for a market marking arrangement.

However should there be a need for a market making mechanism to satisfy other objectives our preference is for one implemented on a market based and incentive driven basis. Such approaches are less interventionist and less distortionary to market and investment confidence.

Snowy Hydro appreciates the opportunity to respond to the Consultation Paper. Any questions about this submission should be addressed to Panos Priftakis, Regulation Manager, by e-mail to panos.priftakis@snowyhydro.com.au.

Yours sincerely,

Kevin Ly
Head of Wholesale Regulation
Snowy Hydro

DETAILED SUBMISSION

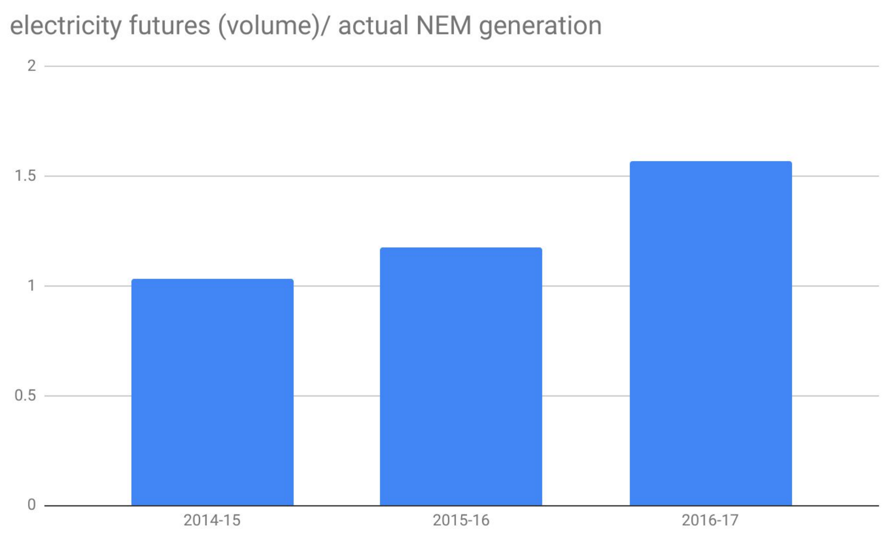
Snowy Hydro recognises that the structure of the electricity market has changed and continues to change however a market making arrangement is unnecessary in a contract market that is liquid and transparent. The industry has worked hard to improve transparency through the recent Australian Financial Markets Report (AFMR). The AFMR survey provides clear evidence that our markets are performing well and contributing solidly to the growth of the Australian economy which clears up misconceptions around the lack of transparency in the market. In addition the number of trades in the NEM continue to be high with numerous power purchase agreements, options and other bespoke contracts between counterparties which can be used to match supply to demand, and mitigate physical and/or financial risk in the NEM which are not mentioned in the consultation paper.

Snowy Hydro does not believe there is a need for a market marking arrangement however should there be one implemented a market based and incentive driven approach is our preference as it is less interventionist and increases the transparency of activities in the contract market. We strongly oppose the proposal for a compulsory market making obligation. The NEM does not need further market intrusion. The compulsory market making if implemented across the NEM, would be ineffective and clearly misguided with the obligation likely to encourage financial misbehavior by participants trying to exploit competitors' enforced buy/sell market making obligations.

The role of the contract market in the NEM

The Commision notes that "*market making is a service designed to increase liquidity of traded commodities or financial instruments*" with the service made "*available in less liquid markets*". Snowy Hydro however believes the industry has ample liquidity and contracts available for market participants through the market. The electricity markets turnover below shows the amount of turnover undertaken in the market. In addition the industry has also responded to transparency concerns with an industry-led AFMR survey providing greater insight into market activity and trends as well as an opportunity for market participants to benchmark performance against an objective standard.

Figure 1: Electricity Turnover by contract volume ('000 contracts)/actual generation in the NEM[1]



[1] Source: 2017 AFMA survey and Department of the Environment and Energy, Australian Energy Statistics, Table O, April 2018

Snowy Hydro notes that wide bid/offers are reflective of taking a position in what may be a high risk and/or highly uncertain in regions. Therefore, if mandatory market making obligation imposes tight bid/offer spreads then this fundamentally increases the risk of participants who will have this obligation. This raises questions, of what are the unintended consequences of such a position? Will it enable speculative misbehavior from those participants and/or speculators who don't have this market making obligation?

When the NEM supply/demand balance is tight, there is no unused capacity that can be conjured up by regulation. The proposal is only likely to encourage financial misbehavior by participants trying to exploit competitors' enforced buy/sell market making obligations.

Snowy Hydro agrees with the proponents concerns that the justification for market making obligations in South Australia has not been adequately addressed by the ESB. The proponent correctly notes that hedging in the South Australia market should be analysed on its own unique characteristics which is a small market with a high penetration of renewables reliant on gas generation to provide firm capacity with important interconnection.

The volume of swap products traded is less than other regions in South Australia although it is a small state in comparison to NSW and Victoria with a relatively small peak demand that is largely oversupplied. In addition, wind output is constrained back at times in South Australia further reducing the liquidity in the market .

Only recently, plans were released in South Australia to increase interconnection by 800MW with the commissioning of the RiverLink project sometime between 2022 and 2024 likely lowering generation dispatch costs in South Australia[2]. A recent report by ElectraNet suggests that it would result in the wholesale price of electricity reducing in South Australia as soon as interconnection is established. It will also result in a reduction in gas consumption for power generation in South Australia, freeing up gas for other uses. The interconnection options between South Australia and NSW provides a benefit through being able to avoid the intra-regional transmission costs that AEMO estimates in the ISP that would otherwise be required to unlock additional renewable generation resources in the Murray River and Riverland REZs.[3]

We therefore support the Commission undertaking a more detailed analysis of the issues in South Australia and the more broadly across the NEM using existing sources such as the AFMR survey where possible.

Market making arrangements in other electricity markets

The Commission identified four jurisdictions that have market making arrangements for electricity futures. Snowy Hydro cautions that care must be taken in making comparisons to the rest of the world or to non-NEM states which are very different markets and whose mechanisms are not necessarily providing the outcomes they were intended to provide. In assessing the non-NEM electricity markets however Snowy Hydro notes that the greatest concerns were noted in countries which implemented a compulsory market marking arrangement.

[2] ElectraNet, 2018, "South Australia Energy Transformation RIT-T Project Assessment Draft Report Summary", << https://www.aemo.com.au/-/media/Files/Stakeholder_Consultation/Consultations/NSP_Consultations/2018/South-Australia-Energy-Transformation---RIT-T-PADR-summary.pdf >>

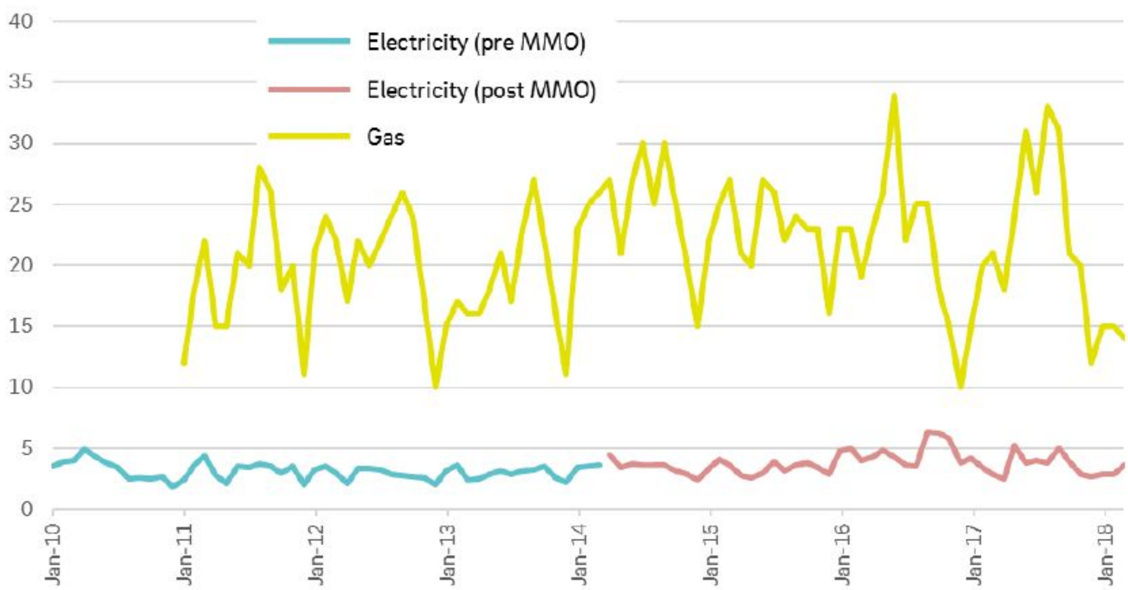
[3] ElectraNet, 2018, "South Australia Energy Transformation RIT-T Project Assessment Draft Report Summary", << https://www.aemo.com.au/-/media/Files/Stakeholder_Consultation/Consultations/NSP_Consultations/2018/South-Australia-Energy-Transformation---RIT-T-PADR-summary.pdf >>

A recently commissioned paper by NERA Economic Consulting on the International Experience of Vertical Integration in the Electricity Sector noted that forcing vertically integrated firms to trade like standalone businesses has little or no impact on liquidity. The report noted that implementing such measures in Britain and New Zealand had not increased either liquidity or competition but merely shifted them into regulated products. The additional regulation likely depressing liquidity.[4]

In the United Kingdom the equivalent to the MLO has brought some benefits to the market, however, these benefits have come at the cost of a subset of market participants while the established smaller players are finding it hard to compete[5]. Five market participants in the United Kingdom are required to cross-subsidise their competitors' risk management activity at an annual cost of some £20 million[6].

E.ON, a UK energy company, recently noted that the UK's Market Making Obligation (MMO) had not improved liquidity in electricity[7]. Ofgem's data showed that churn in the electricity market remained much lower than in the gas market and the trend had not changed since the introduction of the MMO. Figure 2 shows that MMO has provided no underlying improvement in liquidity.

Figure 2: Churn rate of electricity and gas[8]



The New Zealand (NZ) market for futures and market contracts have had a market making obligation (MMO) in NZ and it has provided alot of transparency especially in the retail area. However as the NZ market has grown with the MMO leading to greater risks. The key issue was that the voluntary scheme wasn't really set on a solid foundation.

Singapore uses a vesting contract regime. The Singapore regime is a regulated contracting mechanism which has historically applied in the NEM (with the introduction of Tasmania to the

[4] NERA Economic Consulting, 2017, "International Experience of Vertical Integration in the Electricity Sector"

[5] Andrews, A, 2017, "Is the Secure and Promote liquidity fix fit for purpose?", << https://www.newpower.info/2017/04/is-the-secure-and-promote-liquidity-fix-fit-for-purpose/ >>

[6] RWE, 2017, "Secure and Promote Review: Response to Consultation"

[7] E.ON, "Secure and Promote: Suspension of the Market Making Obligation", response by E.ON to consultation.

[8] E.ON, "Secure and Promote: Suspension of the Market Making Obligation", response by E.ON to consultation.

NEM). Most of the NEM has ample liquidity and Singapore had introduced its market making requirements to try and achieve the kinds of liquidity Australia already have in the market. The Singapore approach however of all the international approaches would be a less interventionist approach that seeks to increase the transparency of activities in the contract market without seeking to address potential market power concerns in contracting markets. The introduction of such a mechanism if mandated would still be a substantial change from the light-touch regulatory approach currently adopted in the NEM.

The Western Australian example is very different to the NEM and care must be taken in making any comparisons between the two. The Wholesale Electricity Market (WEM) has a capacity mechanism and is not an energy-only market. The market demographic is also very different in the WEM as the continued dominance of Synergy in the WEM means that market power remains a headline concern in the market compared to the NEM where there are numerous vertically-integrated businesses operating. Across the NEM, market concentration is also likely to diminish further with the growth of renewables and the closure of Liddell.

Compulsory Market Making obligation

Snowy Hydro strongly opposes a compulsory liquidity obligation on physical participants which would compel certain key participants in each jurisdiction to make additional hedge contracts available during time periods where a shortage of contracts is identified. The compulsory approach if implemented would be ineffective and clearly misguided. There is no amount of unused capacity that can be conjured up by regulation. The proposal is likely to encourage financial misbehavior by participants exploiting competitors' enforced Buy/Sell market making obligations.

Mandatory market making would be extremely problematic for peaking plant such as energy limited hydro generation and open cycle gas turbines. For instance, it is unclear with energy limited generators what the opportunity cost of their generation may be and gas generators would have fuel risks with volume and transportation issues. Hence suggestions of forcing the entity to post tight bid/offer swaps up to its registered capacity is inefficient when the opportunity cost of these energy limited plant changing all the time, and short term spot gas prices can significantly vary on a daily basis.

The compulsory market making requirement will impose potentially very large trading risk with no improvement on liquidity, as shown in the UK above. Snowy Hydro are concerned that any market making requirements will provide a further obligation on market participants to provide market liquidity making it in the process more difficult to meet. The approach which was initially suggested by the ESB, proposed to target some large, vertically integrated retailers in the reliability guarantee. This would add to market uncertainty by singling out particular market participants for action in response to perceived competition shortcomings.

The compulsory market liquidity requirement would simply increase risk to the gentailer which ultimately is passed through to consumers. It also risks inefficient use and misallocation of scarce resources for fuel-constrained plant, again worsening consumer outcomes.

Voluntary market based market marking arrangements

Snowy Hydro does not believe there is a need for a market marking arrangement however should there be one implemented a market based and incentive driven is preferred. Such approaches are less interventionist and may increase liquidity and the transparency of activities in the contract market.

The proposed approaches by the proponent and the ASX Market Making Incentive Scheme are partly complementary both being based on the voluntary participation while expected to cover all regions in the NEM. Should any of the proposal proceed then it is important that the market making obligation proposed by the ESB be removed from the reliability guarantee and replaced with one of the market based approaches.

Snowy Hydro agree with the proponent that the proposal is *"in the long term interests of customers and promotes a number of beneficial outcomes consistent with the NEO that would not be provided by a compulsory market making arrangement"*[9] The benefits of a voluntary approach include that the investor confidence in the market remains, transparaceny, economically efficient allocation of risk in the NEM, commercial drivers left unhindered and encourages participation of specialist providers.[10]

The voluntary proposals minimise the new for market intervention and centralised decision-making. Further to this, Snowy Hydro notes that the voluntary schemes should be given time to work and the proposal to make the scheme mandatory after a period of time should strongly be avoided.

Costs of market making approach

The costs of the any of the approaches have not been set out in the consultation paper. Snowy Hydro understands the costs of each option may vary according to the level of prescription in the arrangement and therefore believes a proper cost/benefit analysis should be undertaken on the chosen approach. We agree with the Commission that the costs are likely to include administrative costs, the cost of the bid offer spread or other incentive required to ensure market making is provided over all contract periods. In regards to the ASX approach, market participants will need time to update systems and processes and to review their requirements under the market making requirements prior to being in a position to either take part in a tender or meet the requirements of an obligation.[11]

Snowy Hydro is concerned that the compulsory market making approach would likely have the most significant costs associated with implementation of all those proposed. The proposal which would compel physical participants to trader contracts they are unwilling to trade free, due to a lack of financial incentives and additional risk exposure, would be significant change in the operation of the NEM and hence a significant costly change to participants[12].

[9] AEMC, Market making arrangements in the NEM, Consultation paper, 20 December 2018,pp15
[10] AEMC, Market making arrangements in the NEM, Consultation paper, 20 December 2018, pp15
[11] AEMC, Market making arrangements in the NEM, Consultation paper, 20 December 2018
[12] AEMC, Market making arrangements in the NEM, Consultation paper, 20 December 2018