MARKET MAKING ARRANGEMENTS IN THE NEM

Response to AEMC consultation paper

February 2019

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1. Introduction

Thank you for the opportunity to provide feedback to the consultation process on the rule change request Market Making Arrangements (MMAs) in the National Electricity Market submitted by Engie.

Market making provides price transparency, liquidity and access to contracts for all participants, including new entrant and small retailers. It also addresses concerns about large, vertically-integrated participants withholding contracts from retail competitors.

Stanwell is supportive of the introduction of market making arrangements in the National Electricity Market (NEM) and has previously advocated for a compulsory approach based on generator market size. As a large participant, Stanwell already supports liquidity through regular informal market making activity and is willing to participate in properly designed compulsory or voluntary schemes.

Overall, a voluntary scheme with strong participation is preferable to a compulsory scheme, however, a voluntary scheme is ineffective if large participants do not volunteer. For this reason Stanwell suggests that if a voluntary scheme is desired that it be funded jointly by the exchange on which the MMA sits as well as by physical market participants who are not MMA participants.

Stanwell welcomes the opportunity to further discuss this submission. Please contact Evan Jones on (07) 3228 4536.

2. Key considerations

Key considerations for a market making arrangement in the NEM include:

- Scope of liquidity issue to be addressed;
- Complementarity with other schemes;
- Voluntary versus compulsory participation; and
- Trigger versus ongoing obligation.

Scope of liquidity issue

In its Retail Electricity Pricing Inquiry (REPI) report, the Australian Competition and Consumer Commission's (ACCC's) expressed the concern from some retailers that the market is not currently providing sufficient liquidity for them to hedge their market risk[1]:

> "In meetings, retailers generally expressed cautious comfort about liquidity in Victoria, New South Wales, and Queensland, though a number of retailers commented that liquidity appeared to have worsened in recent years.
>
> A number of submissions also identified South Australia as having a particularly illiquid hedging market"

The ACCC cited potential reasons for the decrease in wholesale contract liquidity across the NEM over recent years as including the withdrawal of scheduled generation, increasing fuel costs and decreasing fuel availability (particularly gas), increasing market share of variable renewable generation, and vertical integration. These issues are exacerbated in South Australia, given the concentration of scheduled generation ownership and the region's reliance on the interconnection with Victoria. These factors should influence the design of the MMA and the risks involved in participation.

A liquid wholesale contract market is typically characterised by:

- no single transaction being likely to move the price excessively;
- individual trades that are able to be easily executed;
- an ability to trade large volumes of energy in a short period of time; and
- a market that can recover towards its natural equilibrium after being exposed to a shock[2].

A contract market can be liquid even if individual participants are not able to hedge at their desired price, granularity and duration. Stanwell considers that good MMA design should promote liquidity and price transparency, not attempt to deliver specific contract price outcomes. The obligation on MMA participants is to frame the market through a bid-offer spread; they are not obligated to sell wholesale contracts at uneconomic prices.

In its rule change request, Engie highlighted that retailers use a range of products other than wholesale contracts (e.g. weather derivatives, insurance, demand response, Settlement Residual Auctions, inter-regional hedges) to hedge their market risk. New entrant retailers also frequently use structured products such as load following hedges to reduce their exposure. Therefore wholesale contract liquidity of standardised products may not alone be an appropriate measure of the ability of small and new entrant retailers to manage risk.

Complementarity with other schemes

In July 2018, the ASX called for Expressions of Interest in market making in the ASX Australian Electricity Futures, Caps and Options Market to further support liquidity in these markets[3]. Stanwell understands that the scheme is scheduled to commence on 1 April 2019 with a rolling two year term, and is similar to the New Zealand electricity market incentive-based market making mechanism. Stanwell understands that the ASX expects to contract six physical (rather than financial) market makers covering products across the NEM.

[1] ACCC, REPI final report, June 2018, www.accc.gov.au/system/files/Retail%20Electricity%20Pricing%20Inquiry%E2%80%94Final%20Report%20June%202018_0.pdf, p113

[2] AEMC, 2018 Retail Energy Competition Review, www.aemc.gov.au/sites/default/files/2018-06/Final%20Report.pdf, p34

[3] https://www.asxenergy.com.au/newsroom/industry_news/market-making-expressions-of-

The key differences between the ASX scheme and the proposed MMA are the number of participants, the source of incentive funding and the contracted time period:

- The ASX proposes to appoint only a limited number of market makers, to fund the incentive scheme themselves and has selected a contract term of two years; and
- The rule change proposes no apparent limit on the number of successful tenderers, suggests that funding be sought from consumers and that tenders are held every three to five years.

As the ASX scheme will begin within two months, the operation of the ASX scheme could provide useful insights to the AEMC in its deliberations on the rule change.

Any regulated MMA scheme (whether compulsory or voluntary) should be complementary with existing schemes. For example, liquidity will be enhanced if the platform, products and time period overlap with existing schemes. Also the obligation to participate in a compulsory scheme should be deemed met if the participant is already participating in an appropriate voluntary scheme.

Voluntary versus compulsory participation

Stanwell has previously supported a compulsory MMA but also supports a properly designed voluntary scheme. Overall, a voluntary scheme with strong participation is preferable to a compulsory scheme. However, a voluntary scheme is ineffective if some large participants "free ride" the benefits of liquidity created by other market makers without volunteering themselves.

Of the four market making schemes identified by the AEMC:

- The New Zealand and Singapore schemes are voluntary, with the latter having both physical and financial entities participating.
- The United Kingdom scheme is compulsory for the largest energy suppliers, but it is currently under review in light of changing market conditions, the reduction in the number of obligated generators following asset divestment and the increasing costs incurred by the remaining market makers[4].
- Western Australia's compulsory market making was introduced in 2014 as part of the merger of Verve Energy and Synergy, to ensure other retailers were able to access contracts from a dominant vertically-integrated participant[5]. Although scheduled retirement of capacity and new entrants will see Synergy's market share drop to about 50 per cent in 2019-20[6], it will still considerably exceed the highest ownership concentration compared to the mainland NEM regions.

Trigger versus ongoing obligation

Stanwell supports an ongoing obligation for a MMA rather than a trigger which has significant drawbacks for market participants:

- A MMA trigger could result in an on-off obligation cycle. An on-off obligation cycle may cause disruption to both MMA participants' and retailers' hedging and trading operations.
- Generators may need to reserve contracts in case their MMA obligation is triggered which is a perverse outcome for liquidity.
- The trigger would need to be continuously monitored by both participants and the regulator. Determination of the trigger calculation method could be controversial and would entail consideration of the timeframe over which the trigger was measured, methodology to differentiate between temporary decreases in liquidity in response to market-sensitive information[7] and sustained periods of illiquidity requiring MMA obligations, as well as accountability processes.

3. Design elements

Overview

Stanwell supports the implementation of a tender for market making services as suggested in the rule change, where successful tenderers receive financial incentives for participating.

[4] www.ofgem.gov.uk/system/files/docs/2018/08/ofgem_open_letter_-_secure_and_promote_update.pdf

[5] Synergy controlled about 70 per cent of generation in the state following the merger.

[6] AEMO, Electricity Statement of Opportunities, June 2018, www.aemo.com.au/-/media/Files/Electricity/WEM/Planning_and_Forecasting/ESOO/2018/2018-WEM-ESOO-Report.pdf

[7] For example, announcement of the closure of a large power station or major regulatory change.

Stanwell suggests the following design elements, subject to the safeguards detailed in Section 4:

- **Length of tender:** The length of the tender should be three years, to align with the visible market for wholesale contracts and the recently introduced notice of generator closure requirements. Potential MMA tenderers may be reluctant to participate if the length of the tender extends beyond the visible market, as it would be difficult to assess the risk they would be assuming over longer timeframes. The AEMC would need to consider the appropriate amount of time between the conclusion of the tender process and the start of the MMA obligation period.
- **Eligible participants:** Both financial and physical entities can contribute to market liquidity, so both should be permitted to participate. While generators are the natural providers of contracts and retailers the natural buyers, financial incentives may encourage financial players to also tender.
- **Financial incentives:** Financial incentives should be commensurate with the MMA participants' market making terms (that is their agreed spread, daily limit, etc).
- **Penalties for non-performance:** In the event that MMA participants do not fulfil their obligations, Stanwell suggests they should forfeit the financial incentives paid under the tender.
- **Sub-contracting:** As suggested in the rule change, MMA participants should be free to manage their contract position through a number of channels, including sub-contracting of their MMA obligation. Apportioning of MMA incentives and charges would be part of the sub-contracting negotiations.
- **Cost recovery:** Stanwell suggests that physical participants that choose not to participate in the MMA be charged to defray the financial incentives paid to successful MMA tenderers. The charges should be appropriately tiered to the category and size of market participants.

  As the chosen exchange also benefits from the increased liquidity provided by market markers, Stanwell suggests that the chosen exchange should also contribute towards funding the incentive payments. This will promote competition amongst exchanges and reduce the cost of the scheme.
- **Monitoring and review:** Monitoring the operation of the MMA and pre-tender reviews could be conducted by the Australian Energy Regulator.

Products

Stanwell suggests the products offered and the way these products are offered should have the following characteristics:

- **Products:** Quarterly firm swaps and caps that cover the entire obligation period. The choice of either swaps or caps or both should be specified in the MMA agreement and at the discretion of each participant, as not all MMA participants may be able to effectively cover the risk associated with some products (e.g. caps).

  Contracts at finer granularity (e.g. monthly) have different risk characteristics, requiring different market making obligations compared with quarterly contracts. Different rules for different contract tenors would increase the complexity and cost of the market making arrangements.

  As part of the tender process, the regulator could review the MMA products to ensure they remain relevant to changing market conditions. For example, in the future afternoon/evening peak swaps could become the preferred wholesale contract for retailers.
- **Market:** All products should be centrally-cleared to avoid the credit risk of over-the-counter (OTC) products. All MMA participants should fulfil their obligations on a single exchange in order to concentrate liquidity. The exchange selected for the MMA should be subject to competition with each exchange bidding through an offer to partially (or fully) fund the incentive payments.
- **Timeframe:** Stanwell suggests that the MMA commence three years in advance and cease two quarters in advance (i.e. operate over the period T-3 to T-0.5, with no obligation during the six months prior to T). This mechanism would give retailers and customers a reasonable period of time to enter into hedge contracts, while incentivising hedging in advance.

  Three years is typically the visible market outlook for market participants and requiring markets to be made beyond this may significantly increase risk and therefore cost. Ceasing the obligation at T-0.5 would allow market makers time to finalise their fuel and hedging position after the conclusion of the MMA obligation period. In addition, the six months prior to T is already the most liquid part of the forward curve so additional obligations would be expected to provide least benefit during this period.

- **Trading intervals:** The market making obligation should apply during the last half-hour of each trading day to concentrate liquidity. There should be no limitation on individual agreements requiring additional market making activities.
- **Maximum bid-offer spread:** Stanwell suggests a decreasing spread as T approaches to enhance liquidity and access to contracts at appropriate prices. The suggested spread is:
  - 3% for the period T-0.5 to T-1;
  - 4% for the period T-1 to T-2; and
  - 5% for the period T-2 to T-3.

  Appendix A illustrates how these proposed spreads compare to actual spreads over recent years for Quarter 1 contracts in Queensland, New South Wales and Victoria.
- **Minimum contract size:** A volume of 5 MW per side for large MMA participants, 1 MW per side for small MMA participants is appropriate.
- **Cumulative risk exposure:** Stanwell considers that there should be daily or weekly volume limits for obligated MMA participants, tiered to the size of the MMA participant. Stanwell suggests the maximum obligated traded quantity per large MMA participant, per day per contract is 10 MW (i.e. two standard trades per day in each contract) in all regions except for South Australia where, due to the small size of the market, the obligation is proposed to be 15 MW per large MMA participant, per week (i.e. three standard trades per week in each contract). Smaller MMA participants will have lower volume limits. The rationale for these numbers is explained in an earlier submission[8].

  The AEMC could also consider whether a MMA participant's obligation for a particular contract should be extinguished once it has traded a certain volume of this contract over the 2.5 year window.

4. Safeguards

While MMA participants will face financial penalties for non-compliance with their obligations, there will be some circumstances under which MMA participants' obligations should be temporarily suspended. These circumstances are safeguards to ensure MMA participants are not forced to enter contracts against sound risk management principles.

- **Trading halts and the release of sensitive market information:** Stanwell suggests that obligated MMA participants should be able to suspend their MMA obligations due to trading halts or the release of market sensitive information such as changes to the announced date for the closure of a large power station.
- **Large market movements:** Ofgem's review of the United Kingdom's market making scheme found that[9]:

  > "When prices move significantly and rapidly, market makers often have their bids or offers aggressed and then pay a premium to reverse those positions once prices have moved in an unfavourable direction."

  For this reason, Stanwell suggests that MMA participants' obligations be suspended if the market price shifts significantly from the previous traded price or closing price from the previous trading day.
- **System corruption:** MMA participants' obligation should also be suspended in the event that MMA participants are unable to access either their trading systems or the exchange platform.

[8] Stanwell submission to Market Making Obligations in the NEM, ESB Consultation, October 2018

[9] Ofgem, Secure and Promote Review: Consultation on changes to the special licence condition, December 2017, www.ofgem.gov.uk/system/files/docs/2017/12/december_2017_consultation_final.pdf

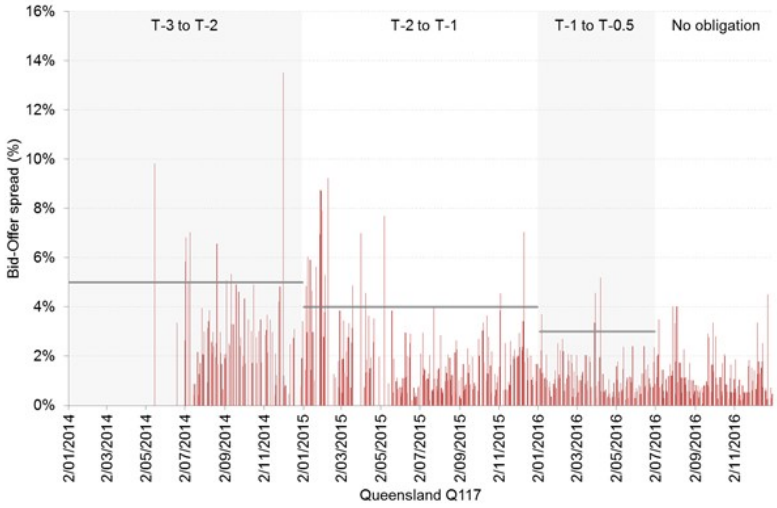
Appendix A – Stanwell's spread proposal

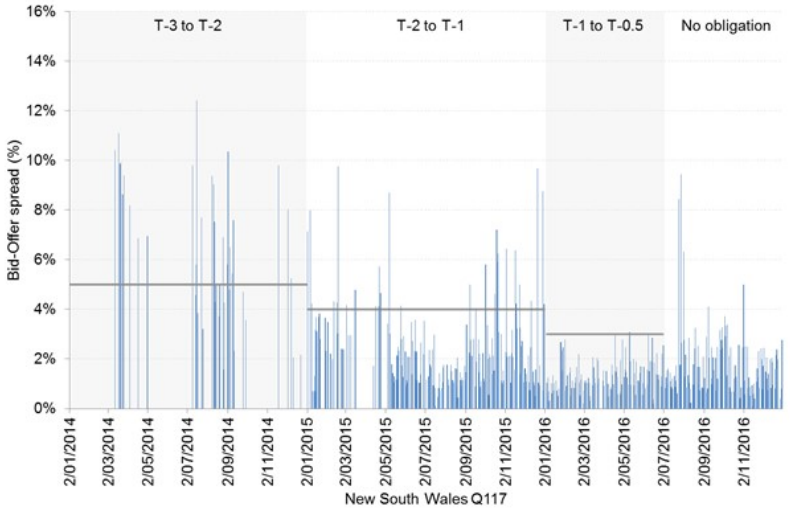
Stanwell proposes that the maximum spread be:

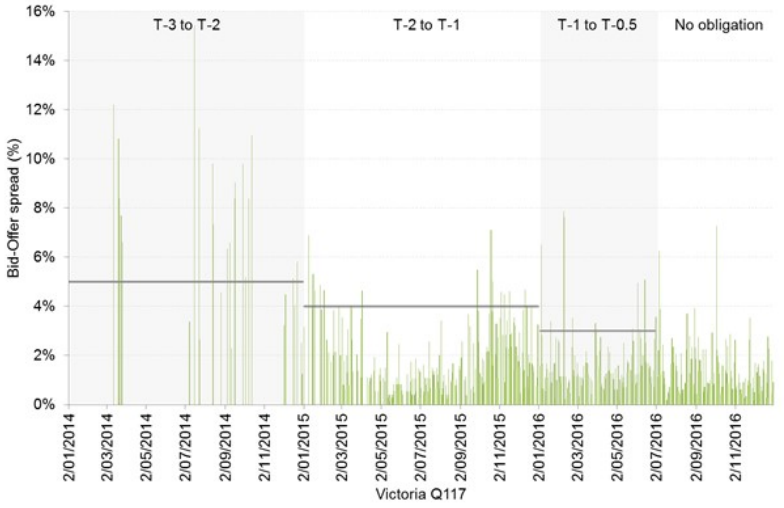
- 3% for the period T-0.5 to T-1;
- 4% for the period T-1 to T-2; and
- 5% for the period T-2 to T-3.

This is to enhance liquidity and access to contracts at appropriate prices. Stanwell's bid-offer spread proposal is mapped against the closing bid-offer spread of various Q1 contracts below.

Quarter 1 2017

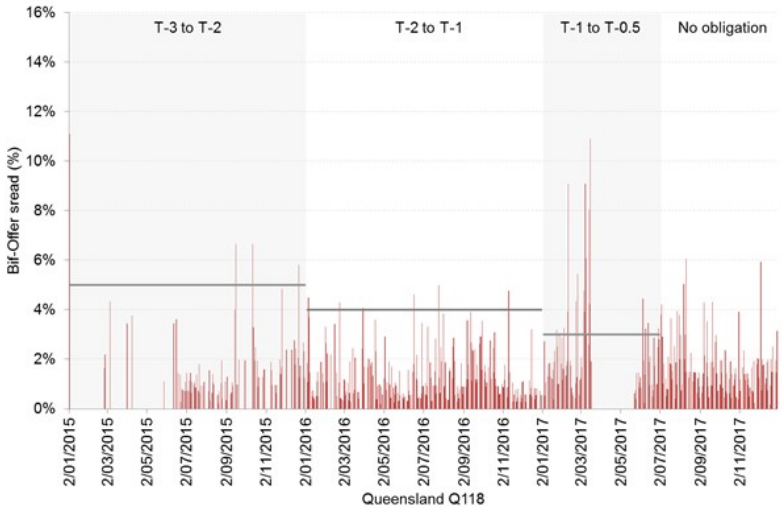


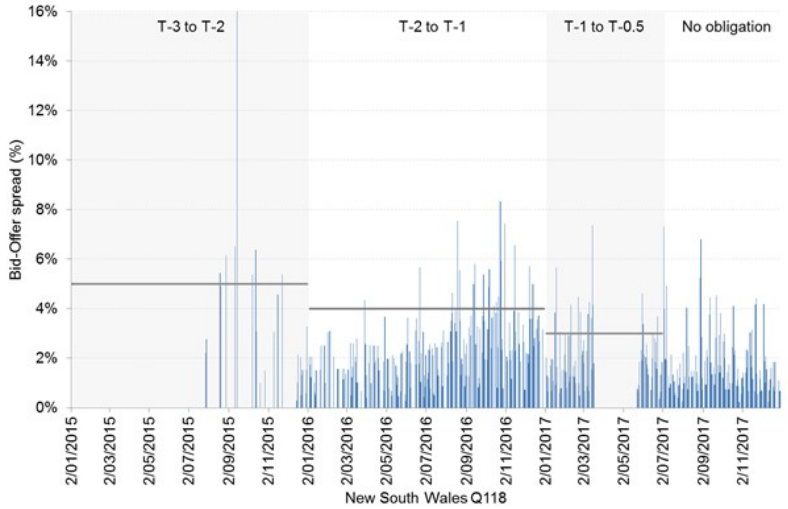


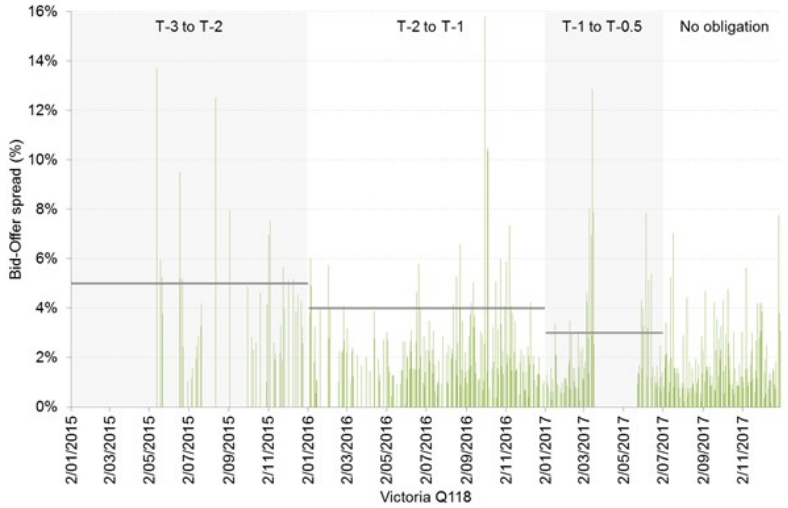


Quarter 1 2018

Data provider is unable to provide missing data in T-1 to T-0.5 period







Quarter 1 2019

Data provider is unable to provide missing data in T-2 to T-1 period