

Our Ref: D19/69078
Your Ref: ERC0259
Contact Officer: Kevin Fincham
Contact Phone: 07 3835 4677
Date: 27 May 2019

Mr John Pierce
Chair - Australian Energy Market Commission
PO Box A2449
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Dear Mr Pierce

Rule change request—Short Term Forward Market Consultation Paper

Thank you for the opportunity to comment on the short term forward market (STFM) rule change request and the related Australian Energy Market Commission (AEMC) consultation paper.

We welcome the AEMC's work on this rule change request to consider how best to provide market participants with greater price certainty and more options to manage their financial risk in the National Electricity Market (NEM). In our view these aims are in line with, and support the achievement of, the National Electricity Objective (NEO).

In particular, we support the evolution of the NEM to promote:

- more options for demand response providers to efficiently manage their exposure to the spot market
- better integration of renewable generation by increasing options for these participants to develop, sell and purchase electricity contract products
- more efficient management of gas-powered generation through better gas-electric co-ordination.

To that end, we support detailed consideration of proposed market reforms that may advance these objectives, including the STFM. Moreover, to the extent that the proposed rule may help to increase liquidity in electricity contracts, we consider this may improve wholesale market outcomes. As noted in our 2018 wholesale electricity markets report, we have observed a general decline in the volume of contract trading across the NEM, and most acutely in South Australia.¹

In our view, the effectiveness of the proposed STFM will depend on the demand for it. Since there are no obvious barriers to its introduction elsewhere by a commercial participant without requiring a rule change, or to the trading of the types of financial products proposed to be traded through the STFM, it is unclear to us whether this demand exists.

¹ AER, *Wholesale electricity market performance report*, December 2018.

In the remainder of this submission, we comment briefly on the importance of considering:

- the proposed STFM alongside other market reforms
- whether there is demand for the proposed STFM
- design elements if the AEMC does adopt the proposed STFM, including:
 - financial service licensing arrangements
 - AEMO operation of the proposed STFM
 - the resulting need for an expanded AER enforcement and compliance role.

Consideration of the proposed STFM alongside other market reforms

In principle and subject to sufficient demand, we agree that a platform such as the proposed STFM might:

- provide opportunities for intermittent renewable generators to manage some of their short-term risk where it is otherwise not covered through power purchase agreements
- assist with gas-electric coordination
- provide further options to assist with demand response integration into the NEM.

However, in our view, the proposed rule change is a significant and complex market reform. We recommend close consideration of the proposed approach relative to other options that may achieve similar objectives more efficiently or are more closely aligned with the long term interests of consumers. For example, when considering how the proposed rule will, or is likely to, contribute to the achievement of the NEO, we encourage the AEMC to consider whether there are other market reforms currently underway that may be alternatives to the proposed STFM—or, if they are complements, how they interact with the proposed market.

There are several relevant rule change proposals and market-based reforms underway that should be considered closely during this rule change process. As mentioned above, these may be alternatives or complements to the proposed STFM, and there may be unintended interaction effects. It is important for the potential benefits and expectations of an STFM to be considered with related reforms and market-based developments in mind. Otherwise, we consider there is a risk that multiple competing markets may add complexity for participants and compromise their individual effectiveness.

For example, we recommend the AEMC assess whether the voluntary ASX market making scheme currently under development² may increase opportunities for demand response providers and renewable generators to access the hedging contracts they need to efficiently manage their assets and businesses. We encourage the AEMC to consider the interaction of the ASX voluntary scheme with the proposed STFM in terms of the design of products for the proposed forward market, the effects of an STFM on electricity contract liquidity levels, and market manipulation risks.

Similarly, the AEMC has initiated the ENGIE rule change request for ‘market making arrangements in the NEM’. This proposal is for a tender-based approach to address contract liquidity problems in the NEM. In our submission to the AEMC on this rule change request, we considered a voluntary market making scheme would be unlikely to address ongoing liquidity issues in the NEM or materially increase incentives for large, vertically integrated businesses to offer contracts.³ When considering the costs and benefits of the proposed

² Scheduled to be introduced by June 2019.

³ AER, *Submission to the AEMC: Rule change—Market making arrangements in the NEM*, February 2019.

STFM, we consider that evidence of demand for such a market, and its products, is an important measure to assess.

Demand for an STFM

In our view, the impact of a voluntary market (such as the proposed STFM) in achieving its proposed benefits or promoting liquidity will depend on a sufficient level of market participation. We expect that significant participation in the proposed STFM will likely be dependent on:

- Sufficiency of current risk management options (i.e. vertical integration, financial hedging contracts through OTC/ASX, other risk management products). In our view, market participants that are already sufficiently hedged are less likely to participate in the STFM. We recognise AEMO has identified in its proposal particular participant characteristics that may benefit from the STFM. We encourage the AEMC to test these characteristics with stakeholders during the consultation process.
- Sufficiency of current price visibility/certainty (e.g. financial derivatives currently traded on the ASX or OTC).
- Sufficiency of information provision in the NEM (e.g. information provided to AEMO as part of pre-dispatch and the introduction of five-minute settlement).

We consider feedback from potential participants about their interest in the proposed STFM will be important in forming a view on its likely effectiveness. For example, in previous consultation processes, we understand that:

- in AEMO's October 2018 industry consultation on this rule change request—'participants considered the impact of the introduction of five-minute settlement and the National Energy Guarantee reliability obligation [now the Retailer Reliability Obligation] and their ability to address the issues the STFM was seeking to address, such as promotion of demand side response'⁴
- during the AEMC's 2018 Reliability Frameworks Review—there were several market participants who submitted there are no existing barriers to the development of a platform for similar day ahead products in the NEM.⁵

Design considerations

If the AEMC does adopt an STFM as proposed, we consider there are several fundamental design features of the proposal which require close consideration, including:

- financial services licensing arrangements
- AEMO operation of the proposed STFM
- need for an expanded AER compliance and enforcement role.

Financial services licensing arrangements

Under the proposed mode, if STFM products are deemed financial products, AEMO, the market, its products and participants will likely need financial services licences, as well as market, clearing and settlement licences under the Commonwealth Corporations Act 2001. AEMO's proposal states that for all NEM participants to trade on the proposed STFM, it will require one of the following:⁶

⁴ AEMO, *Rule change proposal: Short term forward market*, December 2018, p. 15.

⁵ AEMC, *Reliability Frameworks Review: Final report*, July 2018, Appendix A.3, p 133.

⁶ AEMO, *Rule change proposal: Short term forward market*, December 2018, p. 5.

- Participants without an Australian financial services licence (AFSL) to obtain an AFSL—this may not be possible and/or highly costly, which may limit participation for these (generally smaller) participants.
- AEMO, the STFM, its products and participants to obtain an AFSL exemption—this would be a significant, uncertain and sensitive undertaking, depending on the input and consideration of other regulatory bodies.
- Designing the market so it is part of the physical market, in which case AFSLs / exemptions may not be required.⁷ This may exclude participants that are not market generators or market customers (such as some financial intermediaries), which may impact on STFM liquidity and the viability of the proposed market.

In our view, none of the available design options in this respect are clearly preferable and all create significant difficulties. In particular, if the market is based on financial products, the issue of AFSL licensing is a complex, significant design issue, which we expect will materially influence the potential effectiveness of the proposed market. Without an approach to accommodate smaller participants who may not already hold AFSLs, we agree that participation in the STFM may be limited to a small number of large participants for whom the licences are not prohibitively expensive. In our view, that would challenge the proposed benefits of the STFM for encouraging demand response and encouraging better integration of intermittent generation.

AEMO operation of the proposed STFM

Relatedly, we recommend the AEMC consider other market operator options when examining the costs of implementation and operation of the proposed STFM. We recognise there may be advantages in AEMO operating the proposed market due to its existing roles and experience operating the NEM. However, we consider the characteristics of the proposed STFM may be well-suited to operation by an independent third-party. Where possible, we consider it is important to avoid unnecessarily impacting incentives for commercial development of market products.

In addition, we recognise the AEMC's view that there may be limitations on its statutory powers to introduce an STFM operated by a party other than AEMO, or otherwise make a rule providing for an auction to determine the market operator. Should the AEMC determine that the proposed STFM may be viably operated by an independent third party, then few or no rule changes may be required.

Need for an expanded AER enforcement and compliance role

In its proposal, AEMO highlights the importance of addressing market manipulation risks under the proposed STFM. We support this observation, and, if the proposal is adopted, consider it essential for a significant role for the AER in protecting the integrity of the proposed STFM and the NEM by:

- developing a compliance framework
- undertaking increased market monitoring measures
- investigating concerns arising from market monitoring
- undertaking enforcement action where appropriate.

In particular, we recommend consideration of what data and information gathering powers would or should be available in our role of reporting on wholesale markets to allow us access

⁷ A physical market may mean the market and its products are not considered financial products and would not require either a financial services licence or exemption.

to accurate and timely information from market participants. For example, the COAG Energy Council's process to change AER information gathering powers and reform civil penalty regimes,⁸ and the Energy Security Board's consideration of whether to remove restrictions imposed under section 18D of the National Electricity Law (NEL) will have implications for our ability to undertake this role effectively.⁹

We thank the AEMC for the opportunity to submit on this process and look forward to ongoing involvement in the assessment of this rule change request. If you have any questions about our submission, please feel free to contact Kevin Fincham (07 3835 4677).

Yours sincerely,



Paula Conboy

Chair

Australian Energy Regulator

⁸ COAG Energy Council, *Meeting Communique*, December 2019, Available at: <http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/21st%20COAG%20Energy%20Council%20Communique.pdf>

⁹ Energy Security Board, *Consultation paper—ACCC Retail Electricity Pricing Inquiry: Recommendation 41*, February 2019.