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Prabpreet Calais
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Calais

RE: Short Term Forward Market

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC) consultation paper on the Short Term Forward Market (STFM).

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 load¹. 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

General comments

Since the outset of the National Electricity Market (NEM) as an energy-only market, it has relied on a deep and liquid contract market to support risk management for both generators and retailers. Due to the nature of the market, there is established bilateral trading and constant innovation in financial products to meet and manage risks. These are the same risks that the proposed centrally administered STFM seeks to address.

Indeed, in the early days of the NEM, an active STFM did exist. Over time, due in part to a lack of interest and the emergence of alternative products such as day ahead call options, temperature or load activated swing options and metered load hedges, this STFM disappeared. This is not to say that there is no value in a short-term market; participants can and do actively trade in the over the counter (OTC) market to manage their short-term positions. However, the vast bulk of trading is for quarterly and annual products.

ERM Power has also recently offered some day ahead products in the OTC market which has only attracted sporadic interest from the broader market. In practice, only a small number of parties who are already active in the space are willing to take on these products. Our activity has not attracted new participants to the market.

Shorter term products are available on OTC markets with daily call options providing one avenue for participants to access contracts on a short-term basis. Other popular contracts include demand or temperature activated swing options where volume increases from a set base amount based on actual demand or temperature outcomes on the day. The base amount can be either a flat volume or half-hour profile with the swing amount either flat or profiled.

¹ Based on ERM Power analysis of latest published financial information.



Participants also manage volume based risk via the use of metered load contracts where final settlement is based on the actual metered consumption of nominated consumer loads.

The fact that participants already use a variety of contracting options means that they value some degree of short-term flexibility in how they contract. However, while still very useful, this represents a minor part of contracting behavior. Therefore, the costs involved in establishing a centrally administered short-term market may be greater than any benefit that participants will derive from an STFM. Given that the rule change proposes that the STFM will be run by the proponent, the Australian Energy Market Operator (AEMO), this would also impose an additional fixed cost broadly across the market for a highly uncertain benefit.

As a result, ERM Power considers that a rule change to establish the proposed STFM is unnecessary. Existing forward markets operate without the need for formal rules as part of the National Electricity Rules. A centralised STFM could develop in time if participants saw the value in one developing. This does not require a rule change.

ERM Power considers that the proposed STFM is unlikely to promote efficient additional generation investment, as investment decisions are based on the long-term investment environment. As such, longer term contracts are required. It is feasible that an STFM could assist with risk management for a new generator which is not an existing vertically-integrated participant in order to provide a form of outage insurance if the STFM became sufficiently liquid to support this. This, however, is such a niche benefit that it would seem unlikely to provide sufficient broader market benefit to justify the costs involved.

Potential suppliers in an STFM

The AEMC's consultation paper restates the proponent's case that the proposed STFM could allow for a variety of technologies to commit more supply into the market through securing a short-term price for their generation. Technologies such as gas-powered generation (GPG), wind, solar and demand response are highlighted as those which would stand to contribute to the proposed STFM from a supply perspective.

ERM Power questions this assertion. While we consider that an STFM could certainly improve some signals, existing economic drivers and contracting arrangements mean that this may not eventuate as smoothly as the rule change proponent believes.

In terms of GPG, AEMO's rule change request claims that sourcing gas and transporting it for generation is difficult. AEMO then argues that the proposed STFM would allow gas-fired generators to firm up their availability in the short term (ST) and pre-dispatch (PD) Projected Assessment of System Adequacy (PASA) timeframes. ERM Power notes that while volumes may be presented at higher prices in the ST PASA timeframe as detailed in AEMO's 7-day price forecast, reported maximum availability shown in the PASA timeframes is based on current plant availability expectations and forecast ambient temperature conditions. As such, we do not see that the proposed STFM would impact NEM reliability outcomes.

Furthermore, "on day" and "day ahead" gas facilitated by contract terms is reasonably available and this is further facilitated by using "park and loan" arrangement with gas pipelines. Although gas prices may be variable for "on day" gas, it has historically been available as and when required. Gas supply has not been a barrier to physical GPG output.

Ultimately, even if a GPG was contracted via the STFM for the following day, the decision for a generator to dispatch on the day would still be a trade-off between selling procured gas or supplying electricity into the spot market based on the best economic return. The STFM would be unlikely to change these economic drivers.

The proponent's illustrative example also fails to consider the willingness of the GPG to sell contracts during periods of forecast spot price volatility. Selling a short-term forward contract transfers spot price risk to the GPG which, depending on its age or current status, may be unwilling to accept this risk for a short-term (less than a week) return. GPG needs greater certainty in contracting than an STFM can provide to remain economically viable.



Additionally, we query the rule change proponent's assertion that the proposed STFM could allow demand response participants to offer firm contracts into the market. ERM Power has sought to purchase a firm response from customers with demand response capability and third-party demand response aggregators. Yet they have been reluctant to do so, preferring to enable demand response as needed based on their own commercial drivers rather than facing the risk of not delivering when prices could reach the market price cap. There is nothing wrong with this approach per se but consequently, we question whether the STFM would be a sufficient driver on its own to lead to firm offers from demand response providers when the risk against the market price cap of not delivering the contracted supply remains.

Finally, the proponent argues that the proposed STFM would also incentivize variable renewable generators to make contracts available as their output forecasts are more accurate closer to the dispatch date. We agree that forecasts are much better closer to real time and that in theory this would allow them to make contracts available. Practically however, a great proportion of variable renewable generation is already hedged through power purchase agreements (PPAs). Generators with a PPA are therefore already encouraged to dispatch because of the PPA; an STFM will not change these incentives. It is also worth considering that given the high correlation of output from variable renewable generators across the NEM, a generator operating without a PPA may find it difficult to find a willing counterparty for contracting at times of expected higher output given that other variable renewable generators will also be expected to be operating at higher output.

Potential risks of an STFM

We also contend that there are additional risks that the proposed STFM could create. Large generators, and in particular those with significant market power in a given node, could seek to 'buy back' risk on the STFM. This would in turn enable them to change their bids to effectively reduce availability in lower price bands and possibly push up market prices as a result. For example, a generator which had, over a long period, sold 1000 MW in contracts, could seek to buy 100 MW back from alternative sources which would reduce their net contract exposure to 900 MW. They could then bid that 100 MW of generation in at the market price cap knowing that they are at no financial risk if that volume is not dispatched. However, if that volume is needed, they would receive a large financial gain at the expense of the broader market.

In a similar vein, generators could also use this to create arbitrage opportunities over intra-regional constraints to allow them to purchase more contracts to support their overall contract position and lower their generation on one side of a network constraint. Again, this could have the effect of pushing up prices if the constraint binds.

There is nothing inherently untoward in this scenario; generators make their own commitment decisions and the generator is not guaranteed to be dispatched. But the presence of a formal STFM could allow it to occur more readily. We consider that the AEMC must be mindful of this risk and how it could potentially lead to higher prices for consumers in the long term.

Finally, we consider that the implementation of the Retailer Reliability Obligation (RRO) will at times detract from incentives to use the STFM. This is because the broad principle of the RRO is to contract earlier. Contracts struck on a short-term basis will provide less value for retailers as they will be unable to be used for RRO compliance. In the event a gap period is triggered then retailers will largely have managed their load via contracts more than a year in advance. An STFM would therefore provide little value for retailers, and potentially for generators (or demand response providers) who may have already sold an efficient level of contracts. Again, we consider that this is likely to limit the benefits provided by the proposed STFM.

Should the Commission determine that the proposed STFM should proceed then we believe that the Commission should give consideration to the physical operation of the "day ahead" with regards to the contract closing time. We believe closing the "day ahead" contract in line with the 12:30 closure time for the spot market would have benefits and promote consistency between the STFM and the spot market.



Conclusion

There are undoubtedly benefits to both buyers and sellers from having short-term contracts available. There are a range of products that are already being used to create short-term flexibility for market participants. Therefore, we question whether a centrally administered STFM will truly enhance the signals that are already present.

ERM Power does not consider that the proposed STFM will provide enough of an incentive for gas-fired, wind or solar generators and demand response providers to offer additional firm contracts. We believe that existing economic drivers and market dynamics will be the main driver for these types of supply to offer contracts or not, rather than the presence of a formal STFM.

As such, we do not believe that an AEMO-run STFM is necessary at this stage. If the market deems that such an arrangement would be beneficial, one will emerge. Contract markets have played an essential role in the life of the NEM and are used to help underpin the long-term certainty needed for generation investment. A short-term market cannot provide the long-term signal needed to support new generation but can provide some benefits for particular participants.

ERM Power therefore believes that it is better to allow the market to run its course, and take on the risk of establishing an STFM itself, rather than impose broad costs on all market participants for AEMO to run a centrally administered STFM when the benefits are highly uncertain.

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

Yours sincerely,

[signed]

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