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LIGHT THE WAY

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Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Lodged electronically: www.aemc.gov.au (ERC0259)

Dear Commissioners,

AEMC 2019, Short Term Forward Market Rule Change, Consultation Paper

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 capacity in the National Electricity Market (NEM).

EnergyAustralia welcomes the opportunity to comment on AEMO's proposed short term forward market. At this time we do not believe there is sufficient demand to support a mandated trading platform. Further, we do not support obligations being placed on AEMO, or a third party, to provide such a service. The AEMC have not identified any current barriers to third parties developing this service and we believe that if there is sufficient demand, short term products will emerge without a regulatory mandate.

Assessing potential demand for a short-term forward market

EnergyAustralia encourages the Commission to identify the likely demand, and quantify the likely benefits, of introducing a short-term forward market.

In EnergyAustralia's experience there is limited demand for such products. It is currently possible to trade short term contracts with Over-the-Counter (OTC) transactions. EnergyAustralia is rarely approached for these types of trades. If we observed an increase in OTC trading, we would likely request an exchange list these products to reduce transaction costs of trading activity. There would be an incentive for the exchange to offer the product if there was sufficient volume.

The AEMC has outlined several scenarios in which wind and gas-fired generators and demand response providers might see value in selling products in the short-term. However, it is unclear whether there would be sufficient demand to purchase these products.

In general, retailers secure their contract positions well in advance to meet internal risk limits and secure price certainty in a volatile market. For high risk days, retailers currently utilise many different products including insurance, weather derivatives, OTC trading and their own demand response capabilities, and have not actively pursued an additional market for short-term products.

At times when wind is forecast to be strong, and therefore wind generators may wish to sell more contracts at short notice, there is unlikely to be much demand from retailers as spot market prices will be suppressed due to surplus wind generation, and price risks will be low. At times of tight supply and high prices when demand response service providers see an opportunity to sell a product, we do not anticipate there will be significant demand from retailers as it is not clear how often retailers will designate risk-management to the last minute. In general, retailers seek to ensure they are suitably covered for reasonably probable contingency events. Further, in the short-term, the price for contracts is likely to converge towards the expected spot price, suggesting there will be minimal benefits for buyers.

While speculative traders (entities that do not participate in the physical market) could improve liquidity, it is unclear whether they would be eligible to participate in a market operated by AEMO. Should the AEMC propose to provide a financial incentive to third parties to operate the platform, so that speculative traders could participate, it must be very clear what the proposed benefits for customers would be for incurring these ongoing costs.

It is important that the AEMC adequately consider the costs in establishing a new market and confirm that there will be clear benefits for customers in the near term. Recently AEMO has been tasked with implementing a number of platforms to facilitate trading in varying markets, such as the Gas Supply Hubs (GSH) and the Capacity Trading Platform (CTP) and it is still unclear whether there will be sufficient demand to warrant the initial set up and ongoing costs of these.

Interaction with the Retailer Reliability Obligation

It is imperative that the AEMC consider the interaction of this rule change with other related changes to avoid incoherence in policy making. The recently introduced Retailer Reliability Obligation (RRO) aims to ensure liable entities are sufficiently hedged to their 1-in-2 forecast demand a year in advance (T-1) of any reliability gap identified by AEMO. The proposed short-term forward market provides a mechanism for retailers and customers to leave a portion of their contracting and risk management to a much shorter timeframe. It is our view that the STFM is contrary to the underlying principle of the RRO to ensure retailer and large loads finalise their contract requirements further out from any period. As such, implementing a short-term market at this point appears redundant.

Supporting efficient investment in energy resources

It is not clear how encouraging retailers to shift risk management activities to the short-term will lead to long-term investment in infrastructure. The current practice for retailers to contract in advance with generators provides generators with revenue confidence to support investment in the market. Shifting risk management activities to the short-term is likely to erode long-term price signals required for significant generation capacity investment.

AEMO's role in financial risk management

We have reservations about AEMO operating a short-term forward market due to its role as the operator of the underlying physical market, and the subsequent allocation of credit risk to customers.

AEMO does not currently provide financial risk management services. Although it does manage some trading platforms, these trade physical products, rather than derivatives. Trades on the Short-Term Trading Market (STTM) and GSH's are attached to physical deliveries of gas, while the Settlement Residue Auctions (SRAs) allow participants to purchase physical funds that AEMO obtains due to regional price differences. In contrast, the short-term forward market is a purely financial market whereby participants exchange money based on an agreed outcome of the physical spot market. There is no underlying product purchased.

A feature of derivative trading is the management of counter-party credit risk. Derivative products are speculative and, combined with the volatility of electricity spot prices, there is a high potential risk of significantly large losses.

In a derivative market this risk is typically managed by the clearing house who procure margins and bank guarantees from participants. In the proposed rule change the clearing house would be AEMO, but it is unclear what AEMO's risk exposure will be, and subsequently the risk exposure for customers and market participants. If AEMO takes on the credit risk, it is effectively customers who are assuming the risk for speculative trading activities, a risk that customers are not able to manage. If market participants face the counter-party risk, they will be reliant on AEMO to assess credit-worthiness due to the anonymous nature of the market. If there is a lack of confidence in AEMO's approach there is likely to be minimal engagement in the market. Neither customers nor forward market participants are able to adequately manage counter-party risk.

As proposed, establishing a short-term forward market operated by AEMO essentially shifts price risks from the prospective trading parties to AEMO, and therefore customers, or other market participants.

Barriers to entry for financial markets and

The AEMC should not endeavour to reduce financial barriers to entry for participants. These barriers exist to protect customers, and other participants, in a volatile and risky market. In the consultation paper, barriers to entry are identified as "significant creditworthiness and collateral requirements". These barriers exist to protect other market participants and should not be removed. If there is consensus that credit barriers are too high, AEMO and the AEMC should seek to remove these barriers for all participants, not just those trading in a short-term forward market.

Conclusion

In summary, it is unclear to EnergyAustralia that there is a clear benefit to customers to implement this change. The instigation of a short-term forward market will impose costs on customers, but it is not clear that there will be sufficient trading to recover these costs and deliver benefits. While the AEMC have outlined sources of supply, the drivers for consistent demand, which is required to support market liquidity, is less clear. We see no barriers to shorter-term products being listed on an established exchange, such as the Australian Securities Exchange (ASX) or the Financial and Energy Exchange (FEX) Group, if demand for a short-term products was to arise in future.

Further, it is not clear who would manage the counter-party credit-risk in an AEMO-operated market. It is inappropriate for AEMO, on behalf of customers, to assume the risk of high-risk speculative trading activities, and the inability of participants to manage anonymous counter-party risk is likely to reduce market liquidity.

If you would like to discuss this submission, please contact Georgina Snelling on 03 9976 8482 or Georgina.Snelling@energyaustralia.com.au.

Regards

Sarah Ogilvie
Industry Regulation Leader