

4 May 2023

Anna Collyer
Chair
Australian Energy Market Commission



Submitted online

Reference: EPR0091

Dear Ms Collyer,

Review of the Operation of the RRO

The Australian Financial Markets Association (AFMA) is responding to the AEMC's consultation on its Review of the Operation of the Retailer Reliability Obligation (RRO).

AFMA is the leading industry association promoting efficiency, integrity, and professionalism in Australia's financial markets, including the capital, credit, derivatives, foreign exchange, energy, carbon, and other specialist markets. Our role is to provide a forum for industry leadership and to advance the interests of the markets and their respective participants. Our membership is comprised of over 125 of Australia's leading financial market participants, including many of the energy firms who participate in the National Electricity Market (NEM).

AFMA notes that the scope of the AEMC's review is limited to the operation of the RRO and that it will not assess the overall efficiency of the RRO. We have therefore limited our detailed comments to operational issues concerning the triggers, the Market Liquidity Obligation (MLO) and the treatment of entities within corporate groups. While we appreciate it is beyond the scope of this review, AFMA and its members continue to have deep reservations about the appropriateness of attempting to use a mechanism based on financial market contracts to enhance physical system reliability and consider that policy makers should replace the RRO with a more appropriate mechanism to ensure system reliability. AFMA considers that a well-designed mechanism aimed directly at dispatchable capacity in the physical market will be simpler than the RRO and achieve policy makers' reliability objectives without having unintended consequences in the financial market. We would welcome an opportunity to discuss why the RRO ought to be replaced.

1. Weaknesses of the RRO

While we appreciate this review is not focused on the overall merits of the RRO, in AFMA's view it is a flawed mechanism that is unlikely to contribute meaningfully to system reliability and should be replaced. The fundamental flaw of the RRO is that it attempts to deal with the lack of physical dispatchable capacity by mandating retailers enter into an inefficient level of contracting in the financial market. AFMA considers this is an ineffective way to incentivise the construction of

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dispatchable capacity as, in a cash settled financial market such as electricity, there is no direct link between contracting in the financial market and the availability of dispatchable capacity. For instance, an obliged retailer could meet its RRO obligations by purchasing swaps from a purely financial player, this would result in the retailer incurring additional hedging cost (probably above the efficient level they would have chosen to hedge) but would not result in any improvement in reliability.

Ensuring an adequate supply of dispatchable capacity is one of the key challenges facing the NEM. Policy makers are currently working on a range of resource adequacy related reforms to support an orderly transition while preserving reliability, we also note that AEMC is currently proposing that “reliability, system security and the future wholesale market” will be one of their key priorities for 2023-24. In AFMA’s view, policy makers should prioritise development of a solution to the supply of physical dispatchable capacity to replace the RRO. In our view, the proposed Capacity Investment Scheme (CIS) could, if designed well, obviate the need for the RRO.

While also beyond the scope of this review, AFMA similarly wants to highlight the inappropriateness of Ministers being able to trigger T-3 instruments without a previous recommendation from AEMO. The RRO is supposed to be built on a framework of expert advice about when reliability shortfalls are anticipated. Ministers and their departments do not have the expertise to perform this analysis so it is unclear what they contribute to the process. AFMA’s view is that governments should devote their efforts to finding an appropriate replacement to the RRO rather than duplicating AEMO’s work.

Given the effectiveness of the RRO is beyond the scope of this review we recommend that the terms of reference for the Reliability Panel’s 2026 review should include consideration of the interaction between; the market settings, the RRO and the CIS and that the Panel should consider the extent to which the RRO is needed going forward.

AFMA Recommendations

- i. Policy makers should prioritise developing an alternative mechanism, such as the CIS, to ensure physical security and replace the RRO.
- ii. The Reliability Panel’s 2026 review should include consideration of the interaction between the market settings, the RRO and the CIS and that the Panel should consider the extent to which the RRO is needed going forward.

2. ESOO triggers

The RRO was developed with a complicated triggering process built on the identification of reliability gaps in AEMO’s annual Electricity Statement of Opportunities (ESOO). This mechanism is intended to give the market certainty about when the RRO would be triggered but it assumes that the ESOO is only published once a year. Recently, AEMO has developed a practice of publishing updates to the ESOO between annual publications. We note this has resulted in the anomalous position that AEMO has issued an ESOO update indicating that it no longer forecasts a reliability gap in South Australia for Q1 2024; but the AER is unable to revoke the T-1 instrument it made on the basis of AEMO’s previous forecast.

AFMA considers that the processes for AEMO updating its forecasts and for the AER triggering and revoking T-1 instruments should be reviewed. In our view there needs to be a balance between providing the market with certainty, so that it has time to hedge to comply with the RRO, while not

imposing costs on the market when AEMO's latest forecasts do not indicate that there will be a reliability gap. AFMA recommends that AEMO should be required to produce revisions to its forecasts of the reliability gap by 31 Jan; and that the AER should be required to revoke a T-1 instrument where the updated forecasts indicates that there will not be a reliability gap.

AFMA Recommendations

- iii. The process for AEMO updating its reliability gap forecasts should be formalised.
- iv. Updated forecasts must be published by 31 January in the year before they are due to take effect.
- v. The AER should be required to revoke a T-1 instrument when an updated forecast indicates that there will not be a reliability gap.

3. Market Liquidity Obligation

Our members have indicated that the MLO is not working effectively to increase liquidity in the electricity derivative market. They have identified a number of factors contributing to this, including;

- The market making obligation only applies to a small number of generators who are selected on the capacity of their units, not the ability of their portfolio to support market. As a result, there are only a small number of market makers and they may not be the most suitable candidates to make a market.
- The obligation only applies to products covered by the period of the reliability gap, as a result, it does not boost liquidity in other periods, which limits participants ability to manage their risk during the reliability gap period by buying-in adjoining periods. For instance, a participant could potentially manage their risk in Q1 by taking a long position in the preceding Q4.
- Some members have indicated that in a volatile market, the mandated spreads between bids and offers can leave the market makers exposed to the market leading to increased costs.
- Members also noted the widely discussed issues about the ability of participants to access futures markets which have limited participants' ability to access MLO products.

As stated above, AFMA's view is that the RRO should be replaced but we think there may be merit in targeted policy measures to increase financial market liquidity by supporting market making. AFMA considers that policy makers could look to build on the ASX's current incentives for voluntary electricity market makers by adopting something like either;

- the Singapore Energy Market Authority's Futures Incentive Scheme, which supports market makers on the Singapore Exchange
- the NZ Electricity Authority's hybrid approach of supporting both regulated and commercial market making.

These approaches could be more effective than the current MLO as they could bring more market makers to the market and would offer a greater benefit to the market by increasing liquidity at all times, rather than just during the reliability gap period. Incentives to support market making could also be extended beyond the replacement of the RRO to provide ongoing market liquidity.

AFMA Recommendations

- vi. Policy makers should consider replacing the current MLO with models similar to those used in Singapore and NZ.

4. Qualifying contracts and the voluntary book build

AFMA's members consider the specification of Standard Contracts in the AER's Contracts and Firmness Guidelines could be improved and do not see benefit in retaining the voluntary book build mechanism. The RRO allows retailers to count two types of contracts towards their obligations; standard contracts specified in the AER's Guidelines and Non-Standard ones approved by the AER. Our members feedback is that the time and expense involved in seeking approval for non-standard contracts generally makes it commercially unviable they are therefore keen for all of the main types of contract to be specified as standard contracts. They propose that demand linked swaptions contracts, that perform as a swap once a demand threshold is exceeded, should be included as standard contracts and that they should have a firmness factor of 1 when the demand trigger is aligned to the RRO obligation of exceeding the 1 in 2 year peak demand forecast. Additionally, they consider that the threshold for caps to be given a firmness factor of 1 should be increased from the current strike price $\leq 5\%$ of the Market Price Cap to $\leq 10\%$, on the basis that prices are likely to exceed these levels during the reliability gap period.

AFMA's members are not aware that the voluntary book build process has ever been used and do not consider that is likely to be used. They therefore recommend removing it.

AFMA Recommendations

- vii. Demand linked swaptions should be included as standard contracts.
- viii. The threshold for caps to be given a firmness factor of 1 should be increased from $\leq 5\%$ of the Market Price Cap to $\leq 10\%$.
- ix. The voluntary book build process is redundant and should be removed.

5. Aggregation of entities

Many participants in the NEM conduct their business through corporate groups with different companies within the group undertaking different activities, such as; retailing, owning generation and transacting derivatives. Some of our members have indicated that the current RRO compliance arrangements are unnecessarily complicated as the RRO does not recognise the reality of corporate groups and just looks at the hedge position of the licenced retail entity in the group. AFMA considers that retailers should be able to manage their RRO compliance as part of a group, we therefore suggest that they should be able to nominate other entities within the group whose hedge positions could be considered for their RRO compliance.

AFMA Recommendations

- x. Retailers should be able to nominate other entities within the group whose hedge positions could be considered for their RRO compliance.

AFMA would welcome the opportunity to discuss the AEMC's review of the form of the operation of the RRO. Please contact me on 02 9776 7994 or by email at lgamble@afma.com.au.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Lindsay Gamble', written in a cursive style.

Lindsay Gamble
Policy Director