

30 January 2025

Australian Energy Market Commission



Submitted online

## PEC – Draft Determination

The Australian Financial Markets Association (AFMA) is responding to the Australian Energy Market Commission's (AEMC) draft determination on the Inter-regional settlements residue (IRSR) arrangements for transmission loops rule change.

AFMA is the leading financial markets 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 membership base is comprised of over 130 of Australia's leading financial market participants, including many energy firms who are key participants in the NEM and Settlement Residue Auctions (SRA).

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### Key Points

- **Support the AEMC's decision to adopt AEMO's approach to allocating positive residues**
- **We are not convinced that there is a need for a broader review of SRA at this time**

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### 1. Role of SRAs

SRA units are key instruments allowing participants to hedge inter-regional price risk. SRA units allow generators in one region to manage risk of price separation with adjoining regions, allowing them to offer hedge cover in these regions. The ability to manage inter-regional risk boosts liquidity in the electricity financial market and gives retailers access to a larger offering of financial products to manage their spot price risk, which supports them offering competitive products to consumers. AFMA is therefore very keen to preserve the value of SRA units as inter-regional hedging products as we consider they are critical to delivering good customer outcomes.

Project Energy Connect (PEC) is anticipated to lead to a greater volume of negative settlement residues and AEMO considers that the current arrangements for allocating settlement residues will not be appropriate for it. AFMA considers that AEMO has undertaken a sound process to develop its implementation approach that has appropriately considered the views of stakeholders, including our members, and reached an appropriate balance that preserves the firmness of SRA units and manages negative residues. AFMA supports the AEMC's decision to adopt AEMO's approach to allocating positive residues and to continue separating positive and negative residues. AFMA does not have a view on the AEMC's proposal to alter the allocation of negative residues between transmission network service providers but considers it is consistent with preserving the value of SRA units.

### 2. Proposed review

AFMA supports the AEMC's decision to not make fundamental changes to the SRA framework as part of this rule change, but we do not agree that there is a need for a more fundamental review at this stage. AFMA agrees that the market is changing and that it is appropriate to continue to review market

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settings to ensure they remain fit for purpose, but we note that negative IRSRs remain a relatively small part of the NEM, amounting to ~\$54m in the last 12 months, just under 11% of the value of positive residues,<sup>1</sup> or ~0.3% of total value of electricity bought in the NEM.<sup>2</sup> While there is some evidence that this number may be trending upwards, we think the small size of these payments compared to overall NEM means there are limited gains to be made by reviewing the SRA arrangements at this stage.

We also want to provide the following observations on part 4 of your paper:

- *Consumer Benefit* – the paper contains a number of comments questioning if consumers benefit from the current arrangements. We want to note that a fundamental feature of the NEM is that all market costs are ultimately borne by consumers and that the purpose of the market is to minimise those costs and allocate them as efficiently as possible. In the case of positive residues, the most efficient arrangement has been to allocate the residue as a hedging instrument that can be used to reduce participants costs of serving customers. Negative residues have not been seen to have the same hedging value, so the costs have been directly allocated to customers.
- *Hedging spot price risk not IRSR* – the paper talks about SRA units as a mechanism for hedging IRSR and comments that “it is not clear why [netting positive and negative residues] would reduce the firmness of the hedge” as it would reduce the volatility of total IRSR payments.<sup>3</sup> AFMA just wants to comment that participants use SRA units to hedge exposure to inter-regional spot price risk, not exposure to IRSR. Netting positive and negative residues would diminish the value of SRA units for this purpose as it would reduce the correlation between the value of the SRA units and the value of the energy flowing between the two regions.
- *Value of SRA units* – The paper posits that consumers are not benefiting from SRA units as “SRA proceeds ha[ve] proven to be much lower than the average value of positive IRSR over time.”<sup>4</sup> We want to make the following observations:
  - i. The revenue from the SRA is only part of how consumers benefit, the other part is the benefit they receive from retailers reduced hedging costs as a result of the use of SRA units to manage inter-regional price risk.
  - ii. SRA units should be expected to sell for less than the total value of positive IRSR as if they did not there would be limited incentive for anyone to buy them. The price of SRA units is determined by the market with their pricing in part determined by the cost of other types of hedge cover that could serve as a substitute for them, particularly the costs of swaps and caps in the relevant region.
  - iii. While in recent years the revenue derived from SRA units has increased in line with the overall increase in energy prices, participants percentage returns from buying units have been decreased since 2010 and we consider on average reflect a reasonable risk adjusted commercial return.
- *Market for a negative residue instrument* – Conceptually auctioning negative IRSR in a similar way to positive residues to allow them to be used as hedge products is attractive, but AFMA does not think it would be successful as we doubt there would be demand for this product. Positive residues are generated when a low-priced region exports power to a high-priced region. In this context SRA’s are valuable as they essentially allow participants to benefit from this valuable trade. Negative residues on the other hand are generated from an inefficiency in the market where a high-price region exports to a low-priced region. In this scenario, the

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<sup>1</sup> <https://aemo.com.au/energy-systems/electricity/national-electricity-market-nem/market-operations/settlements-and-payments/settlements/settlements-residue-auction/settlement-residue-auction-reports>

<sup>2</sup> <https://aemo.com.au/-/media/files/electricity/nem/national-electricity-market-fact-sheet.pdf>

<sup>3</sup> p40 AEMC Draft Determination

<sup>4</sup> p41 AEMC Draft Determination

generators in the exporting region are already receiving the higher price and have no interest in being exposed to the lower price and likewise customers in the lower priced region are already paying the lower price and have no desire to be exposed to higher prices. It is unclear to us who would want to buy a negative residue linked product and we suggest this is why the cost is allocated directly to consumers.

**AFMA Recommendations**

- i. AFMA does not consider there is a case for a fundamental review of SRAs at this stage.

AFMA would welcome the opportunity to discuss this submission further and would be pleased to provide further information or clarity as required. Please contact me at [lgamble@afma.com.au](mailto:lgamble@afma.com.au) or 02 9776 7994.

Yours sincerely,



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