NEM Review Secretariat

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National Electricity Market wholesale market settings review – Market Making Obligation Design Paper

The Australian Energy Council ('AEC') welcomes the opportunity to make a submission to the Expert Panel's Market Making Obligation Design Paper.

The Australian Energy Council is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

Overall views on the Paper

The AEC supports the design objective of the MMO – namely to ensure liquid, transparent and accessible contract markets. We believe that market making can play an important role in achieving these objectives:

- Liquid, transparent and accessible contract markets are essential to enable participants to manage risks, support investment and promote competition.
- Market making provides a valuable service supporting liquidity and efficient price discovery.
- A well-designed package of contracts, trading platforms and market making requirements can help deliver liquidity, transparency, and accessibility.

However, market making is a complex, risky and specialised financial service. To support efficient provision of market making services they should be valued and rewarded by the market. Procurement should enable the most efficient providers. And as far as practical, market making should be voluntary and remunerated.

Mandatory market making obligations should be designed to address the barriers to efficient commercial provision, ensure the benefits exceed the costs, and minimise unintended distortions. Given the intention to embed a broad a 'mandatory' market obligation as a central feature of the future market design it is critical that the risks are appropriately managed. The opportunity to encourage commercial market making as a supportive complement to the mandatory obligation should be explored.

The MMO design paper identifies the key design questions to inform the MMO design. The rest of this submission responds to each of the questions raised in the MMO design paper.

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| Expert Panel question | AEC views |
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| What market participants should an MMO apply to and what thresholds should apply? | |
| Which entities should an MMO apply to? Should it be focused on those with the largest market share in each of the three different electricity services (both wholesale and retail) that will underpin the ESEM (bulk, shaping, firming)? Should it cover large electricity consumers and what threshold should apply? Are there other alternative approaches? Please explain your reasons. | Any MMO design should ideally ensure the obligations are only imposed on the products and regions where the intervention is required (eg. Where liquidity in core products is below a defined threshold).<br><br>An always on MMO which is targeting better price discovery should apply to a broad range of entities. The MMO should apply on the sell and buy side, covering both generators and retailers.<br><br>The ESEM warehouse should also act as a market maker. The ESEM warehouse is likely to hold a large volume of contracts (based on CIS experience to date) and the entity could facilitate trading by taking on credit risk. The ESEM warehouse could also market make in longer tenors (say 3-5 years) and smaller volumes (100kw rather than 1MW) if the Panel believes that is a worthwhile policy objective.<br><br>The obligated parties should not be required to make markets for services they do not offer. That is, if an operator provides predominantly bulk VRE services, they should be required to offer firming services. We are open to a commercial market making operator, and note that the entities that the MMO applies to should avoid crowding out the potential for a commercial operator model.<br><br>A complexity to note is that the traditional model where asset owners also have trading teams, meaning it is clear what entity should be obligated will change over time. In particular, the Capacity Investment Scheme (CIS) will foster large quantities of bulk VRE and storage, and CIS entities are required to set up single asset Special Purpose Vehicles (SPVs). It may be the case that the CIS entity does not have ongoing operational control over the asset. For example, a CIS entity may enter into a tolling agreement for its battery – in this case, the obligated party should be the entity with those tolling rights, not necessarily the CIS entity.<br><br>The design of MMO capture and thresholds should seek to minimise distortions and allow captured participants the maximum practical flexibility to transfer the obligation to the entity best placed to manage the obligation, taking into account the specific circumstances of the asset and the organisations.<br><br>The MMO obligation should be able to be separated from the AEMO registration to allow one party to own and operate the physical asset (and be fully accountable for compliance under the NER) while another party is legally responsible for the MMO. |

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| | It should also be noted that MMO entities would be required to trade derivatives, which requires them to hold a Australian Financial Services (AFS) licence. This would include the ESEM administrator, to the extend the ESEM warehouse was included. |
| What is an appropriate percentage market share threshold to apply? | Care should be taken in setting thresholds, as it is likely that the traditional model where asset owners control those assets as market participants will change. That is, asset owners under the CIS may be more passive asset owners with other market participants controlling those assets via arrangements like tolling (for example). The MMO obligation threshold does not lend itself to simple market share calculations. More generally, any thresholds should be forward looking to consider relevant changes in a market participants asset base (eg. Generator closure).<br><br>The thresholds set should be reviewed every two years as part of the AER ESEM contracts process the Panel has recommended. |
| Should thresholds be set out in the NER or in an MMO guideline? | MMO guideline, and thresholds will vary widely depending on the underlying market structure and asset mix in each relevant jurisdiction. Thresholds should be informed by an analysis of current and target liquidity levels for each relevant jurisdiction – if the gap is large, thresholds arguably could be lower than where liquidity is already at a healthy level. |
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| Contracts for which services should the MMO apply to? | |
| Do stakeholders agree that the MMO should cover contracts for bulk, shaping and firming services? Please explain your reasons. | MMO should apply across bulk, shaping and firming contracts. It should start with existing core contracts currently utilised by market participants to hedge financial risk (i.e. swaps and caps). This is a prudent approach that would allow sufficient time for any new products identified through the co-design process to be developed and listed on an exchange, with the suite of MMO products then potentially expanded beyond swaps / caps over time should a market for the new products develop as intended. A commercial market-making framework could also be implemented to support trading of the new contract-types.<br><br>Appropriate coverage will depend on the final form of contracts that are designed for generation, shaping and firming. Concentrating liquidity in a few contract types across firming and may be more efficient for the purposes of the MMO. The NEM is a relatively small market with liquidity inherently divided across 5 separate pricing regions.<br><br>Even two MMO products for each of the 3 services would divide liquidity across 30 separate products. |

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| | The value of liquidity, transparency and accessibility of applying the MMO to VRE generation contracts may be less likely to exceed the cost. Participants required to trade firming and shaping products may be better placed to manage any supporting generation contracts they need to manage their position.<br><br>Deciding what contracts form part of the MMO should be done through the contract co-design process currently being progressed with industry. |
| Should the MMO also apply to contracts that package up all three core services (bulk, shaping and firming) into a single contract for sale to retailers and end users? | Yes, although in practice we expect bulk VRE would need to be firmed to create fungible contracts anyway. A combination could also be complex to express as a derivative, so it may be retailers prefer to build their own book. |
| Should the MMO apply to existing contracts in the market? Please explain your reasons. | Yes it should. It should not be limited to only ASX contracts. |
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| Should the MMO only operate on exchanges or can it also apply to over-the-counter trading? | |
| What conditions would an OTC platform need to meet to be a candidate for the MMO? Please explain your reasons. | The MMO should allow obligated participants a choice of several platforms. The criteria for eligible platforms should be determined based on their ability to contribute to liquidity, transparency, and accessibility.<br><br>OTC platforms should be allowed to participate in the MMO for a few reasons. Relying only on the ASX could hold back the contract innovation required. Also, large customers prefer OTC and contracts tailored to their individual circumstances.<br><br>Need to consider carefully how individual counterparty credit requirements is captured and the interactions with liquidity under the MMO. |
| Should the MMO be open to any exchange that meets pre-defined criteria set out in the rules and approved by the AER? Please explain your reasons. | Yes provided the platform meets relevant AER criteria. It should be up to the relevant platform whether it wants to participate on a voluntary basis. |

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| Should there be limits on the number of exchanges and platforms on which the MMO applies? | There is a balance to be struck here. If another platform can develop an approach which serves the market, it should be included to foster innovation. However, a proliferation of platforms could be unwieldy, so we would expect three or so platforms to be workable. |
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| What is an appropriate bid/offer spread and how should this be determined? | |
| The Panel seeks views on the principles that should underpin an efficient bid/offer spread that would deliver increased liquidity in the NEM contracts market. Are there other principles that should be included? | Ideally, the MMO would be voluntary and incentive based, so that market participants are not exposed to being forced to take on a risk position they are not comfortable with or places them at odds with their risk management mandates. The bid / offer spread in a mandatory market making obligation should be wide to minimise the risk of market participants being forced to take on this risk. If spreads are too thin, market making becomes commercially unviable. Spreads should not be too rigid but allow for adaptation as market conditions, contract types and underlying technologies evolve. We think limiting the period that MMO applies to be longer dated periods reduces the risk of short-term shocks to the market that causes extreme volatility. Only having the MMO on longer dated periods say >1yr <5 yrs will encourage earlier trading. |
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| Over what time periods and for how long should market making occur? | |
| The Panel seeks views from the Policy Advisory Group on whether these arrangements should be extended to the proposed MMO framework or modified. Please explain your reasons. | The Panel's hypothesis is extending MLO arrangements on trading windows and exemptions makes sense. We agree. |
| Should MMO providers be able to access exemptions from providing market maker services for a specified number of days? Please explain your reasons. | We do not think exemptions should be preset and based on a number of day. Rather, they should be circumstance based. Any circumstance which would give rise to a breach of an entity's AFS licence, for example, should enable an exemption. Preexisting regulatory commitments cannot be breached as a function of a new MMO obligation.<br><br>The framework should also be sufficiently flexible so as not to result in market makers having to take sub-optimal risk positions and potentially impede their ability to efficiently manage their own customer demand. The need for this flexibility would be heightened where a tight bid / offer spread is mandated.<br><br>Consideration could also be given to granting exemptions to the extent a maximum loss limit was breached. |
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| What volumes should MMO participants be required to trade? | |

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| What is an appropriate level for maximum contract parcel that an MMO provider should include in their bids and offers? | To clarify, we believe the MMO is a requirement to offer, not to trade. A 1 MW parcel size is reasonable. |
| What should be the appropriate minimum volume levels for MMO providers and how should these be calculated? | Care should be taken to avoid setting minimum volume levels for MMO providers based on nameplate capacity for a few reasons. First, ageing assets may not be able to support requirements based on nameplate capacity as they approach the end of their engineering lives. Second, as discussed previously, asset owners may not retain operational control over the assets where they have entered tolling arrangements. The methodology should be set out in guidelines, and minimise the risk that market participants are being asked to take on.<br><br>Consider the idea of minimum being linked to the size of the market and MMO participant share. Further work needed to refine this approach, including how obligations would be assigned to parties in multiple jurisdictions. |
| Do you agree with the Panel's view that volume limits are not necessary for the MMO? Please explain your reasons. | We think there should be a limit on the volume of contracts a MMO is obligated to transaction on a net basis. This mitigates the risk that market participants may be required to sell/buy more than what they can physically back based on their portfolio/requirements based on customer size. |
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| What entity should administer and enforce the MMO? | Consistent with the broader NEM architecture and government there should be a separation of governance roles to provide confidence and stability.<br>• Key parameters should be set in the Rules and developed by the AEMC. This should include the key risk settings around spread, volumes, application etc. It may be desirable for the AEMC to seek advice from the Reliability Panel in relation to ongoing development of these features.<br>• The AER should be responsible for the operational compliance and enforcement of the rules, including developing appropriate guidelines for subsidiary parameters. |
| Do you agree with the Panel position that there should not be a specific cost recovery mechanism for MMO market makers? Please explain your reasons. | No we do not agree. It is not reasonable to assume that a commercial market making operator would need to be compensated, but that market participants would do so as it is commercially attractive. If this were the case, market participants would be doing so on a voluntary basis, obviating the need for a market making obligation. |
| The Panel seeks observations on the governance of the MMO including the extent to which design | Some MMO governance matters would best be captured in the NEL/NER. For example, the concepts that these obligations are subservient to things like AFS licence and competition law. Other design elements like what are the standard products, which MMO exchanges can participate could be dealt with in AER guidelines. |

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| components should be included within the NER or AER guidelines | We think a regular review requirement, say each 2-5 years is important to ensure the MMO design is achieving its objectives. |
| The Panel seeks views on the timing of the introduction of the MMO including its initial application to existing contract frameworks and its evolution to the new contracts developed through the co-design pilot process that is currently underway. | Our preference is for the MMO to initiate once detailed design has been completed, including the contracts co-design process and ESEM arrangements. The MLO would need to be wound down ahead of the MMO starting, and the RRO should also be abolished prior to the MMO. |
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| Should the MMO be supplemented by a commercial market maker? | |
| Do stakeholders consider that the MMO should be supplemented with a regulator led commercial market maker model? Please explain your reasons if you agree or disagree. | Market making is a valuable, complex, risky service. It should be voluntary and remunerated. We support commercial operators being paid to provide market making services.<br><br>If market participants pay a commercial operator, their obligation is met that way. If market participants perform market making themselves, they would not be expected to contribute to the costs of a commercial market making operator. |
| What is an efficient way to allocate the costs associated with commercial market maker services? | Market participants who utilise the commercial market making services would pay on a fee for service basis. Those market participants who self-provide market making would not be required to fund any commercial market maker. |
| How should a commercial market fee be determined and by whom? | We anticipate a periodic auction would determine who will be the commercial market maker. |

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