19th October 2018

Dr Kerry Schott AO
Energy Security Board

Submitted via e-mail to: info@esb.org.au

Dear Dr Schott,

Market Making Requirements in the NEM

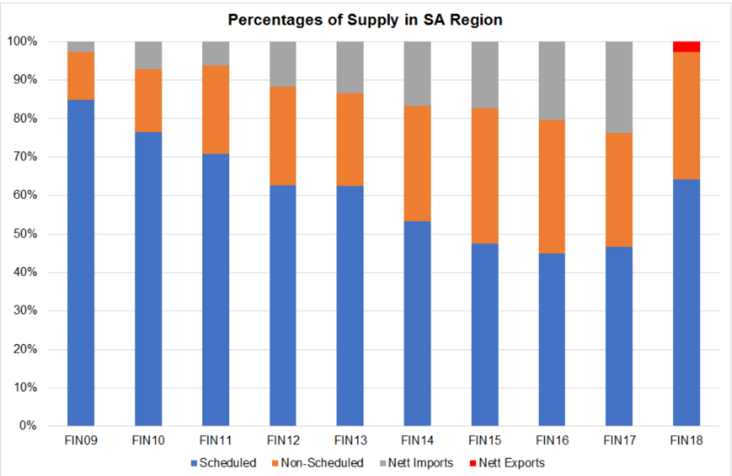
The Australian Energy Council (the "**Energy Council**") welcomes the opportunity to make a submission in response to the Energy Security Board's ("**ESB**'s") *Market Making Requirements in the NEM Consultation Paper*.

The Energy Council is the industry body representing 22 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over ten million homes and businesses.

Introduction

South Australian historical peak demand was 3,397MW on 31st January 2011.[1] Its time-weighted average demand over the past financial year has been approximately 1,300MW. To supply this demand it has approximately 5,600MW of local generation,[2] less than 3,000MW of which is dispatchable, and 820MW of interconnection to Victoria. There are plans to increase this interconnection by 800MW with the commissioning of the RiverLink project sometime between 2022 and 2024. The largest dispatchable generation plant is the 800MW Torrens Island B Power Station. At face value, the region is oversupplied.

The ACCC Report[3] showed at Figure 5.3 (and reproduced in the Consultation Paper on page 7) that physical demand in South Australia was approximately 3TWh in each of Q3 2017, Q4 2017 and Q1 2018, and concluded that since the volume of flat swap products (ASX and OTC) traded was less than 2TWh in each of those quarters, liquidity was inadequate.



While it is true that the volume of swap products traded is less than other regions, SA is in a unique position by having dispatchable (scheduled) generation being replaced by variable renewable energy generation, to the extent that last financial year the state was a nett exporter of electricity, as shown in the graph. In this sense reporting aggregated financial derivative trade volumes is not a relevant measure for the region, since an increasing proportion of supply is being provided by generation which is not capable of writing firm derivatives such as swaps and caps. In the case of SA it is fallacious to assert that supply is compromised by the absence of financial derivative products when

[1] https://www.aer.gov.au/wholesale-markets/wholesale-statistics/seasonal-peak-demand-occurrence-region
[2] https://www.aemo.com.au/-/media/Files/Electricity/NEM/Participant_Information/NEM-Registration-and-Exemption-List.xls accessed 2nd October 2018
[3] Australian Competition & Consumer Commission, *Retail Electricity Pricing Inquiry – Final Report*, June 2018

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the state clearly has ample supplies on both a megawatt and megawatt-hour basis, and interconnection provides another avenue for supply into the region.

Therefore the proposed market making obligation is not helpful for the purposes which the ACCC identified, and the Energy Council would argue that any obligation imposed on market participants to provide market liquidity will prove increasingly more difficult to meet, as conventional generation is displaced by variable renewable energy generation with little or no marginal cost. The Energy Council also notes that the proposed Reliability Guarantee may alter the economic difference between the various types of generation, and consideration should be given to the expected change to the market and its effect on participants, particularly so-called "obligated parties".

Nevertheless, the Energy Council's members are keen to work with stakeholders to address any perceived shortcoming in market liquidity and agree on appropriate assessment mechanisms and triggers, and to that end the Energy Council's Wholesale Markets Working Group is considering developing its own rule change proposal which would apply more broadly.

Discussion

Identifying Obligated Parties

While hedging activity can be assessed in terms of flat swaps and caps, there are also power purchase agreements, options and other bespoke contracts between counterparties which can be used to match supply to demand, and mitigate physical and/or financial risk. The imposition of a simplistic market liquidity obligation, with its focus on "vanilla" products may act to stifle product innovation, and reduce opportunities to provide the best possible products to the market.

The ESB has proposed a number of different methods for selecting obligated participants. The Energy Council believes that imposing selection criteria in this way will affect market participants' ability to optimise their business structures, and compromise the agility of their businesses to respond to changing market conditions. Linking to businesses' retail licences is an artificial construct and does not take into account the businesses' generation product offerings, while measures such as generator market share do not reflect the need for counterparties to mitigate financial risk in the NEM, which may or may not best be addressed via contracts with physical generation.

Market Making Requirements

It is important that the market making obligations do not impose a substantive compliance burden on obligated parties, by limiting the time prices are to be made available, and restricting refresh requirements. In addition it is important that any market participant's offering is not made to the detriment of their broader business or in contravention of organisational risk management policies (such as credit risk exposure or counterparty concentration), and therefore it will be important to set reasonable bid-offer spreads, restrict the volumes traded in respect of particular quarters and consider other settings which may affect businesses' ability to make bids and offers. The Energy Council agrees that safeguards will be important to minimise obligated parties' risk and maintain market stability, and suggests that consideration be also given to obligated parties' ability to make bids and offers, for example when their generation is expected to be unavailable in the trading period. In addition it is important that the timing of any obligation is appropriate, to allow obligated parties to confirm their fuel arrangements and assess their generation positions.

Conclusion

In closing, the Energy Council urges caution in the ESB's consideration of market making obligations for the NEM. Imposing further compliance obligations on market participants arbitrarily identified and declining in their ability to make product offerings in the face of changing market conditions is not expected to achieve the effect desired by the ACCC. Nevertheless, the Energy Council and its members are keen to work with stakeholders to address the issues perceived by the ACCC, and are interested in exploring the development of a robust, equitable market liquidity obligation.

Any questions about this submission should be addressed to the writer, by e-mail to Duncan.MacKinnon@energycouncil.com.au or by telephone on (03) 9205 3103.

Yours sincerely,

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