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Submission to Recommendation 41 Consultation Paper – AER monitoring of contract markets

AGL Energy (**AGL**) welcomes the opportunity to comment on the Energy Security Board's (**ESB**) consultation paper on Recommendation 41 of the Retail Energy Pricing Inquiry (REPI), being AER monitoring of contract markets (**Consultation Paper**).

AGL is one of Australia's leading integrated energy companies and the largest ASX listed owner, operator and developer of renewable generation. Our diverse power generation portfolio includes base, peaking and intermediate generation plants, spread across traditional thermal generation as well as renewable sources. AGL is also a significant retailer of energy and provides energy solutions to over 3.5 million customers in New South Wales, Victoria, Queensland, Western Australia and South Australia. We are active in financial derivatives markets in the states we operate in, including the emerging gas contract market.

Objective of Recommendation 41

The REPI made several recommendations relating to greater transparency around financial markets. Recommendation 41 of the REPI states that:

The AER's wholesale market monitoring functions should be expanded and appropriately funded to include monitoring, analysing and reporting on the contract market. This should include analysing the data reported to the OTC repository (recommendation 6), ASX data and data gathered directly from retailers and generators (including through the use of compulsory information gathering powers).

The reason provided for this is:

The wholesale market monitoring powers under the NEL require the AER to consider whether there is effective competition within a wholesale electricity market. In assessing effective competition the AER must have regard to whether there are active competitors and whether they hold a sustainable position, whether prices are determined by cost or whether there is a degree of market power, whether barriers to entry are low, and whether there is independent rivalry.

The AER's current market monitoring powers do not specifically extend to monitoring of contract markets. The critical nature of contract markets for the effective functioning of the electricity supply chain is discussed in chapter 5. In order to improve transparency in contract markets, chapter 5 recommends (see recommendation 6) that data on over the counter contracts be reported to the AER and made publicly available in a de-identified format.



The Consultation Paper goes further and makes the following comments:

- Contract markets are critical to the operation and effectiveness of the gas and electricity markets. They allow participants to manage risk and can support new investment. The degree to which participants have entered into contract markets is likely to affect behaviour in the gas and electricity spot markets.
- The linkages between financial markets and spot markets can provide opportunities for cross market manipulation. The example provided is that the AER cannot effectively monitor compliance with the market manipulation provisions in the National Gas Rules at Wallumbilla because it does not have access to off-market bilateral contracts.
- Access to contract market information would help AER assess performance and competitiveness of markets over the long term.

Therefore it appears the purpose of Recommendation 41 is to enable the AER to more effectively assess competition in wholesale markets, by providing it with access to information about financial contracting markets.

We note, however, that off-market gas contracts are physical contracts and therefore the issue at Wallumbilla identified by the ESB would not be addressed by Recommendation 41.

AGL was supportive of improving the transparency of OTC contracts (REPI Recommendation 6), so long as the information was reported in a suitably aggregated format with commercially sensitive information protected, and the administrative costs of reporting were minimised. We considered that greater transparency would help to reduce information asymmetry in the market and assist with monitoring trends over time.

While the ESB has decided not to proceed with Recommendation 6 (as the costs of reporting to and maintaining an OTC contract repository were found to outweigh the benefits of improved transparency alone), AGL continues to support improved market information that can assist businesses make more efficient decisions (again, so long as confidential information is suitably protected and administrative costs minimised).

ASIC is responsible for regulating and monitoring contract markets

The consultation paper is seeking feedback on the proposal that the AER should monitor, analyse and report on the contract market, with associated information gathering powers. While AGL appreciates that the AER may find it useful to access certain contract market information that is not otherwise publicly available to help inform its wholesale market monitoring functions, it is not necessary for the AER to monitor activity in the contract markets themselves, or be given powers to compel this information from market participants.

These functions are the responsibility of ASIC, who for example has the power to:

- make derivative transaction rules under section 901A of the Corporations Act;
- regulate and monitor holders of an Australian Financial Services Licence regarding compliance with the obligations set out in section 912A of the Corporations Act;
- monitor and investigate market manipulation, which is prohibited under section 1014A of the Corporations Act.



We appreciate that electricity derivatives are currently exempt from ASIC's broad requirement that OTC contracts be reported to a centralised repository. This exemption was considered by the AEMC in the "NEM financial market resilience" review, which was completed in March 2015. In that review the AEMC found that the costs of complying with reporting requirements for electricity derivatives would outweigh the benefits, and noted some of the differences between financial and energy markets (for example that energy trading is predominantly conducted by physical participants and is not speculative). The AEMC is expected to reconsider whether this exemption remains appropriate in 2019, taking into account the transparency measures that have evolved outside of ASIC (such as the Australian Financial Market Association survey of electricity OTC contracts).

Even though electricity OTC contracts are exempt from the reporting requirements that apply to other OTC contracts, ASIC has the power to (and does) investigate and review how these contracts are being traded, as it considers necessary. For example, in 2014 ASIC investigated the risk management policies of market participants that trade OTC electricity derivatives.¹ This involved the use of information gathering powers to obtain specific information from participants.

The AER should not be responsible for monitoring contract markets

Given the role of ASIC in monitoring derivative markets, AGL does not consider it appropriate or necessary for the AER to also be involved in monitoring, analysing and reporting on contract markets, or hold the associated information gathering powers. This would be duplicative with existing ASIC obligations and therefore provide little additional value, while also creating a risk of administrative burden on participants. To the extent that any reporting or monitoring gaps are identified, they should be addressed through ASIC's functions.

In general, we consider the existing AER powers to monitor wholesale markets and the restrictions around its information gathering powers to be appropriate and provide suitable limitations to the collection and use of data for different purposes. Where there are rules to prohibit certain behaviour, the AER can investigate suspected breaches. It would not be appropriate for the AER to have the power to compel information from participants unless it reasonably considers a rule has been breached. Investigations without cause would result in significant administrative burden on market participants.

In addition, AGL is concerned with the suggestion in the Consultation Paper that contract information reported to or obtained by the AER would be used to monitor suspected issues such as market manipulation. We note that energy-only markets such as the NEM have very different dynamics to capacity markets, in which market manipulation rules exist in other jurisdictions. In energy-only markets generators recover their long run marginal costs in times of tight supply and high prices, and high prices provide signals for additional generation to be built. This is becoming more pronounced as the NEM transitions to greater levels of renewable generation and more volatile spot prices. Without the right expertise, it would be difficult to differentiate legitimate bidding behaviour from market manipulation.

If market manipulation is to be investigated, there needs to be careful consideration of the meaning of market manipulation in an energy only market context.

¹ <https://download.asic.gov.au/media/1344566/rep390-published-17-April-2014.pdf>



An appropriate role for the AER

While we do not consider the AER should take on a broader monitoring role for contract markets, if considered necessary AGL would not oppose the AER having greater access to contracting information for the following purposes:

1. Informing its existing wholesale market monitoring function.
2. Publishing aggregate information over time: although as noted below, the AFMA survey is currently providing this information to the market.

These functions are consistent with the AER's proposed role under the Retailer Reliability Obligation. Assessing qualifying contracts under the Market Liquidity Obligation will be an administrative function and therefore different to the broader monitoring and enforcement carried out by ASIC.

AGL suggests that to the extent any new functions are introduced for the AER that relate to contract markets, there should be explicit clarity on the collection and use of that information.

OTC contract repository

One of the options raised in the Consultation Paper was to provide OTC contract information to the AER through an OTC contract repository. While we were supportive of this in our submission on Recommendation 6, we note there may be more cost-effective ways to obtain the required data than setting up an OTC contract repository. For example:

- The Australian Financial Market Association survey could be improved to better capture the type of information needed by the AER.
- The AER could request and receive certain information from ASIC, where ASIC holds that information.

If you have any queries about this submission, please contact Jenessa Rabone on (02) 9921 2323 or JRabone@agl.com.au.

Yours sincerely,

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