



6 March 2018

Dr Kerry Schott

Chairman

Energy Security Board (ESB)

By email to: info@esb.org.au

Dear Dr Schott,

Re: National Energy Guarantee

Thank you for the opportunity to make a submission on the National Energy Guarantee Draft Design Consultation Paper dated 15 February 2018.

Introduction

ASX is supportive of the key objectives of the National Energy Guarantee (NEG). ASX believes that an open, competitive and transparent market place is the best way to address these issues and develop solutions that deliver on both climate policy objectives, price transparency and system reliability and security requirements.

Long-term policy direction built on sound principles will provide the market place with stability and confidence. Sound policy is required to enable the energy sector to grow, adapt and innovate in the face of challenging dynamics.

ASX's submission does not attempt to cover all of the issues raised in the consultation paper but focuses on important questions around how wholesale emissions, price and supply risks would be best managed. In particular, we focus on the critical role that financial products and financial markets can play in facilitating the risk management activities of entities operating within the National Energy Market. We believe that the Energy Security Board can play an important role in ensuring that this aspect is appropriately reflected in the design elements of the NEG if it is to operate in the most effective and efficient manner.

About ASX

ASX supports Australia's energy markets through the operation of its existing securities and derivatives markets and its payments platform (Austraclear). ASX also provides opportunities to invest in publically listed energy, renewable energy and clean technology companies.

ASX energy markets are comprised of futures and options over Australian Electricity, New Zealand Electricity and Natural Gas. ASX Australian Electricity futures and options are standardised and centrally-cleared financial contracts. They are structured as cash-settled swaps against the NSW, Victorian, Queensland and South Australian regional reference nodes in the Australian National Electricity Market (NEM). They provide a robust mechanism for companies that have an interest in or exposure to the NEM to anonymously manage price and counterparty risk. In 2017, some 350 million MWh's of Australian NEM based electricity were transacted and cleared on the ASX's Trading and Clearing platform, which is supported by a \$650m guarantee fund that significantly reduces counterparty and systemic risk. Currently ASX has open contract volume of 66,000 lots, representing 141.5 million MWh of energy with a face value of \$9.64 billion.

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Delivering the NEG objectives

ASX believes that market-based solutions, with the support and guidance of policy makers and regulators, can deliver the NEG objectives. In evaluating possible solutions, we believe that there are two principles which provide a helpful additional framework for assessment. These are:

1. **Preservation and transparency of forward prices.** Any solution should preserve and promote transparency and liquidity in forward prices. Forward price signals are fundamental to investment decisions and also for risk transfer. Any failure to meet this test is likely to result in higher electricity prices, and risks a lack of investment in electricity generation.

The electricity contracts currently listed on the ASX are the only mechanism in today's National Electricity Market which enables participants to explore future price expectations and hedge their price risks.

2. **Counterparty risk mitigation.** Any solution must take account of the counterparty credit risk issues inherent in the electricity market. Central clearing is a valuable tool in addressing counterparty and systemic risk and has been increasingly mandated or incentivised by regulators post-GFC to address counterparty risk and interdependency issues in financial markets. A further benefit of central clearing is the material netting efficiencies which can often be realised, relative to the risk exposures resulting from multiple bilateral contracts. Central clearing is likely to continue to be a helpful tool in the Australian electricity market for mitigating these long-term counterparty risks and reducing overall systemic risk.

One risk we perceive in the NEG information to date is the suggestion that the emissions and reliability requirements could be met by increased use of long-term, bilateral, generation-backed delivery contracts. Post GFC, global regulators have recognised the material credit risks in OTC bilateral contracts and have worked to increase central clearing for systemically important contracts and counterparties. The current centrally-cleared arrangement used by the NEM participants aligns with global regulatory guidelines and standards, namely a regulated, transparent clearing venue, where counterparty risk, systemic pressures and clear audit trails can be managed by the clearing facility and overseen by the local regulatory bodies.

ASX believes that these principles provide a helpful additional framework to ensure that the National Energy Guarantee achieves its policy outcomes whilst minimising the risk of unintended consequences such as reduced sectoral investment in the absence of a reliable, publicly available forward price signal.

Addressing the NEG requirements

ASX believes that each individual requirement – namely the Emissions requirement and the Reliability requirement – should be dealt with separately, each with its own contract market. A successful market depends on being able to generate sufficient activity in standardised products. The electricity market, by its very nature, is already complex, with multiple contracts for different regions, time periods and types of supply. We have some concern that the suggestion in section 3.3.2 of 'stapling' specified emissions levels to existing contract products would fragment the product base, potentially splitting liquidity across too wide a set of contracts to support a transparent forward price curve. However, we believe that an Emissions contract, separate from the existing Electricity contracts, could operate very effectively, either on a state-specific or national basis.

Emissions

A contract market to meet the emissions requirement could be established using contracts that specify by region (if needed), but not by energy source, emissions per MWh. For example, a market that allowed generators to sell contracts based on their emissions per MWh would provide a price signal for emissions that was technology-neutral, whilst still

enabling different state jurisdictions to establish their own targets if required. An emissions contracting arrangement could be structured around annual forward contracts, traded on exchange, providing a transparent price.

In response to Section 3.6.2, we agree that a compliance registry would be needed to manage the emissions requirement. One option for further consideration is whether Austraclear could be used for this purpose. Austraclear is Australia's bond CSD and high value payments platform, and is already used by all NEM market participants for settlement of spot market payments with AEMO. Certificates representing emissions could, for example, be issued by AER into Austraclear as dematerialised annual certificates, in a similar way to existing bank bills or corporate bonds. AER could transfer these certificates to generators based on its emissions calculations, enabling retailers to either purchase these contracts directly from generators to meet their emissions obligations, or to use emissions futures contracts for hedging, delivering certificates on expiry.

We agree (per Section 3.3.3) that a deemed emissions level would need to be assigned to contracts in the existing contract market. We believe that the proposed approach (per region, based on emissions for electricity generated in that region for the past year) is likely to be a reasonable and transparent method, although it may be appropriate to adjust this backward-looking measure when regulators are aware of material changes in the current year (e.g. new generating capacity with emissions levels differing from the deemed level coming into use) which would change the position significantly.

Reliability

ASX agrees (section 5.2) that building on existing market arrangements in the design of the reliability requirement would be advantageous. Leveraging proven market solutions should aid speed to market and minimise the complexity of the changes; it would also be helpful in preserving a transparent forward price signal in the futures market. We agree (section 5.6.1) that the further use of existing cap contracts could be a very effective mechanism for ensuring that supply is available to fill the gap. Given that only certain types of generators would be able to sell caps, confident in their ability to deliver electricity when needed, this would strongly incentivise the creation of additional deliverable capacity when future cap prices are higher.

A further alternative might be the creation of a new type of Reliability Gap product to support the NEG. A discrete contract market could be created where the Reliability, or Gap, requirement is allocated to retailers. These retailers would buy contracts according to their allocation, from sellers whose right or ability to sell Reliability Gap Contracts was restricted and verified by accredited and quarantined sources.

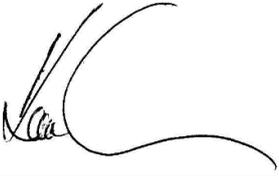
ASX recognises that a blend of different approaches to reliability may be desirable, and that the ideas on certification of bilateral contracts, or physically-backed contracts, could be a useful complement to the exchange-listed Cap product. However, it is important to note that such bilateral arrangements introduce additional counterparty credit risk into the electricity market. A material shift to bilateral contracts (or vertical integration) has also been seen to have the effect of reducing market liquidity and forward price transparency. One approach, to avoid damaging forward price transparency, could be for retailers in some cases to contract directly with specific energy generators for reliable supply, but using floating rate contracts where pricing is determined by spot prices throughout the supply period. Both parties would then have the opportunity, if they wished, to hedge their price risk through existing ASX futures contracts.

Conclusion

Both the Emissions and Reliability solutions, if traded on-exchange, provide forward price transparency, credit intermediation and, importantly, concentrate liquidity to achieve the most cost-effective outcome.

ASX looks forward to further discussions with the ESB, regulators and industry participants to discuss these ideas in more detail and to help deliver on the objectives as set out in the NEG.

Kind regards

A handwritten signature in black ink, appearing to be 'Ken Chapman', written over a thin blue horizontal line.

Ken Chapman

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