Ms Kerry Schott
Independent Chair
Energy Security Board
info@esb.org.au

Friday, 19 October 2018

Dear Ms Schott,

ESB Consultation Paper: Market making requirements in the NEM and

Notification of intention to lodge a proposal to amend the National Electricity Rules

ENGIE in Australia and New Zealand (ENGIE) welcomes the opportunity to make a submission in response to the Energy Security Board's (ESB) abovementioned consultation paper.

The consultation paper provides an important consideration of the interaction of the Australian Competition and Consumer Commission's (ACCC) Retail Electricity Pricing Inquiry - Final Report (Retail Report) recommendation 7, and the detailed work undertaken by the ESB in development of the National Energy Guarantee.

Overview

ENGIE holds a relatively unique position in the market because of the transition it has implemented in recent years. This has seen ENGIE evolve significantly with the strong growth of its retail business, Simply Energy, and the subsequent large reduction in its generation portfolio, with the sale of Loy Yang B and closure of Hazelwood Power Station. As such, ENGIE has operated on multiple sides of market in the context of the issues raised in Chapter 5 of the ACCC's Retail Report.

Likewise, as a participant in South Australia, and all other National Energy Market (NEM) jurisdictions except Tasmania, ENGIE can juxtapose its experiences within these jurisdictions to shed additional light on the issues raised by the ACCC, and which form the basis for the ESB's consultation paper. ENGIE's retail business, Simply Energy, has operations in Western Australia and thus we have experience in that market also, while internationally, ENGIE operates in several markets that have considered or implemented market making obligations.

This submission touches upon some of the issues raised by the ESB; however, it also concludes that several fundamental questions around the justification for market making obligations, either in South Australia or more broadly, have not been adequately addressed or addressed at all. Introducing a requirement that will force specific market participants with physical generation to buy and sell contracts they would be unwilling to trade freely, due to a lack of financial incentives and additional risk exposure, is a significant change in the operation of the NEM. Such a change needs to be deeply considered and cautiously assessed.

As such, ENGIE, which does not support the introduction of the proposed market making obligations based on the evidence set out date, is proposing to lodge a rule change with the Australian Energy Market Commission to allow for a detailed and structured assessment of market making in accordance with the consultation processes market participants are familiar with.

Such a step will supplement the ACCC's suggestions and the important consultation paper published by the ESB. It will also allow for additional issues to be raised and examination of the merits of all potential solutions against the status quo.

South Australia

As a business with ongoing operations in South Australia, ENGIE does not believe the justifications outlined by the ACCC are sufficient. Raising a concern that small retailers may have difficulty contracting in the manner they prefer does not of itself make that concern valid or necessitate action. Especially action in a form that shifts risk to parties who would be obligated to contract outside their existing risk appetite.

The analysis by the ACCC assesses the competitiveness of the South Australian market against two primary benchmarks. First, the ability of small retailers of unspecified financial viability to obtain contracts at the price and of the duration that they desire. Second, contract liquidity of the smaller South Australian regions against the larger regions. The conclusion in this context, and set against the spectre of vertical integration, suggests that market making obligations is the solution. This is despite the acknowledgement prices for trades of bigger and smaller participants in South Australia were largely the same.

ENGIE does not support the ACCC's assessment because they have not effectively diagnosed the South Australian market conditions nor made a link to conclude market making as proposed will solve the challenges some suggest are present in South Australia. While the consultation paper provides a more detailed analysis of the characteristics of market making, it wasn't drafted with the intention of assessing the ACCC conclusion or providing more detailed evidence. In ENGIE's view, a more detailed analysis of the problem and proposed solutions is still required.

This means the primary issue, South Australian market outcomes compared with other jurisdictions remains insufficiently discussed with a weak evidence base to support market making as an actual or preferred solution.

Hedging in South Australia

Hedging in the South Australian market needs to be assessed in comparison to other jurisdictions on the basis of its unique characteristics: a small market with a high penetration of renewables, reliant on gas generation to provide firmness, and with important inter-connection with Victoria.

The implication in the consultation paper is that as the ACCC found vertical integration provides internalised risk management services across the integrated company this means that vertically integrated electricity companies are withholding hedge products from competing retailers, that is, that they have the capacity to provide additional hedges but choose not to do so even at the cost of not entering hedges at all. There is little evidence, if any, that this is the case. Further, gas generation is unlike baseload coal-fired generation and assessing all large generators in a similar manner lacks sophistication and appreciation of the specific, significant issues that gas fired generation faces with respect to gas market liquidity.

Gas market dynamics

Unlike coal-fired generation, gas generators are driven by the dynamics of the underlying and less flexible gas market both in terms of liquidity and granularity of contracts. Willingness to contract is driven by gas positions and gas supply in a way that fundamentally differs from baseload coal operations.

Unlike non-export black coal or brown coal, which is best ultilised as fuel for generation, a gas position may be better utilised to meet retail demand, delivered to large users directly, taken to other markets, or not taken so as to on sell pipeline transportation.

Therefore, in such a complicated market, where a decision to generate with gas cannot be assumed, expecting gas-fired generators to provide the same level of liquidity as coal-fired generators in the larger regions is mistaken. This issue was not adequately addressed in the ACCC Retail Report or by the ESB.

Notably, while reference has been made to the United Kingdom scheme, generators in the United Kingdom scheme of market making can really on a very dynamic and liquid gas market which differs from Australian arrangements. This includes for South Australia.

Experience of firm generators in South Australia

Further, the recent history of South Australia shows that interest in contracting with physical participants is mixed, which contrasts with the ACCC's conclusions and the intent of the consultation paper.

Significant effort was made by the last operating, now closed, coal-fired generator to contract with customers before closing, and similar efforts were made and the absence of parties willing to contract with Pelican Point was noted before that plant was withdrawn from the market. It has since returned.

The fact is that customers, including small retailers were very willing to 'ride' the spot market on the expectation prices would remain supressed and new renewables and gas fired generators with loss making must run take or pay contracts would maintain this downward pressure. Only with changes to firm generation, that were rational and appropriate, have those parties come to regret their decisions as volatility increased. This is not a failing in the market but a failing in customers' contracting strategies. Volatility is now encouraging greater contracting, which is how the NEM is expected to function.

Notably, one of the drivers of the National Energy Guarantee reliability mechanisms was to obligate large customers to contract where it was clear an absence of contracts, including in South Australia, has led to generator's closing or being mothballed when they were in fact needed in the market for security of supply. But the market making discussion has somewhat turned this argument around whereby now a perceived problem with vertical integration and contract withholding, without evidence, is the most critical driver of lower liquidity in South Australia.

Interestingly, in its current deliberations on the future of the United Kingdom scheme, Ofgem has acknowledged that the finding by the Competition and Markets Authority that they "have not identified any areas in which vertical integration is likely to have a detrimental impact on competition for independent suppliers and generators" is an important consideration in considering whether the special licence conditions which mandate participation in market making should be withdrawn.

Further, smaller retailers having trouble hedging at the desire price and duration is not of itself a market failing. Especially if those small retailers are not financially capable of managing the risk needed to trade or desire below market priced trades. A barrier is problematic if it is an artificial constraint, not if it is a legitimate cost of doing business which an inexperienced party cannot manage. Again, with reference to the United Kingdom, an alternative policy for small market participants, and not market making was developed to support the challenges raised by the ACCC.

ENGIE can only note that it is more the willing to continue to trade with willing market participants and invites small and large customers to make contact to discuss contract availability in South Australia.

Market making obligations likely to create several challenges

If the intention is to try and shift risk from one party away to another then perhaps a market making obligation could be successful albeit blunt instrument. But such an outcome will have obvious consequences which have not had an opportunity to be considered.

Changes won't necessarily improve risk management and trading

Firstly, it cannot effectively change the total capacity to manage risk in the market. This means when an obligated party is forced to take on one form of risk they don't have an appetite to hold, they will need to rebalance their operations or contracting in other areas to maintain a similar overall risk exposure.

For example, an obligated party may change its internal risk management approach, allocating more hedge contracts to the traded market even if its related retailer then bids into the traded market for hedges previously provided internally. This will lead to a loss of efficiency, but unless anti-competitive withholding is occurring, the total supply of risk management instruments should not change.

This is consistent with findings in the United Kingdom and New Zealand market making schemes, where the increase in liquidity occurring within the trading windows appears to be accompanied by declines in liquidity outside the trading window. Similarly, improvement in the liquidity of specific mandated instruments appears to have been achieved at the expense of lower liquidity in other previously traded instruments.

In the United Kingdom in particular, ENGIE's experience is that liquidity inside the trading windows did not greatly assist small participants who remain reliant on arrangements with larger players. Those larger players now need to engage a small team of traders who are dedicated to managing the risk associated with the mandated trading window. When a mandated offer is 'lifted', the affected player then instantly seeks to 'hit' another mandated player's offer to manage the risk (i.e. close out the position). This has under some circumstances increased volatility, cost (e.g. by crossing the spread to close position) and risk.

Notably, while the overseas market making obligations were cited by the ACCC, little attention was given to the worth of those schemes or their general health. ENGIE's operations in Europe indicate that the scheme in the United Kingdom is on the verge of suspension given problems that have arisen. ENGIE understands the scheme may be suspended during November 2018.

Credit quality cannot be ignored

Second, it may change access for contracting parties, but to the extent that access is provided to contracting parties with lower credit quality, it won't eliminate the costs of lower credit quality. The costs of lower credit quality flow from the higher risk of a loss given default or failure by a low rated counterparty relative to a counterparty with higher credit quality. Increasing an obligated party's exposure to lower credit quality counterparties inconsistent with its risk appetite is likely to result in higher costs to all customers.

If market making is implemented through exchange traded contracts, both parties to a transaction incur higher working capital costs through the application of margins to exchange participants. If implemented through contracts for differences, the cost to the provider are managed through rationing trades with counterparties according to their credit worthiness, or providing for margins, or both.

The United Kingdom market making scheme separately provided for common documentation – ISDA Agreements used widely across the Australian market being similar – but allowed for different treatment of counterparties. Such an arrangement would be needed in Australia to manage risk exposure. However, should this arrangement be permitted it would likely negate the value of market making for those small retailers who face contracting hurdles because they are riskier counterparties.

Growing a small retail business involves specific challenges

Third, it remains unclear whether it would allow small counterparties to enter the market because trade sizes are unlikely to be small enough to cover the issues faced by small retailers. This is because whether 1 megawatt or 5 megawatts, traded markets provide relatively blunt risk management instruments for new entrants without scale. As noted earlier, it is also why the United Kingdom scheme was not in ENGIE's view targeted at small purchasers with alternative policies developed for that purpose.

Physical players have natural limits they cannot exceed with consequences

Fourth, the market making obligation will not increase hedges available beyond the underlying generator's ability to meet its financial obligations. Generators, whether vertically integrated or not, are not typically speculators. As a generator's contract book approaches the spot period, its outstanding contracts will tend to shrink to or below its expected value of generation over the relevant period. As identified, changing contracting patterns reduces the efficiencies provided by vertical integration.

In fact, the obligation may reduce the obligated parties risk tolerance. This is because higher levels of risk taking may provide a portfolio benefit, where the integrated retailer and generator are on different sides of the risk. Where the risk or benefit is externalised and does not provide a portfolio benefit, a generator may be reluctant to take on the same level of risk, given the possibility of a loss to it without a commensurate gain.

Operating constraints may negate the value of market making

The ESB quit rightly notes that generator outages and fuel availability (gas liquidity is a material and key issue in South Australia) needs to be considered in the context of market making obligations placed upon physical participants. This is because market making can't result in generators offering contracts where their generation availability is affected by factors such as conditions in fuel markets, physical constraints and prices in hedge markets.

Economic and physical fuel constraints (adverse weather, drought, interruptions to coal supplies, inability to source gas permanently/at short notice/in sufficient quantities and granularity) and uneconomic input fuel costs (high gas prices) are all reasons why a generator, whether vertically integrated or not, cannot sensibly provide hedge contracts up to the full extent of its risked capacity.

Once all these factors are taken into consideration, for most, if not all, generators, the outcomes should reflect the hedge offerings which are in accordance with the existing business plans of those physical generators.

It is not appropriate for obligated parties to take on unnecessary costs

Sixth, market making shouldn't force obligated parties to trade at a loss.

The analysis by Ofgem of the United Kingdom's scheme provided evidence that the costs of the scheme, measured by the inability of obligated market makers to move their prices sufficiently and rapidly during periods of high volatility, resulted in costs significantly higher than was anticipated.

Additional and significant IT costs were also faced by obligated parties who implemented detailed algorithms to determine the appropriate prices in given trading periods.

If obligated parties faced losses this will impact future capacity availability and investment.

Are mandatory obligations on physical participants the only option?

In addition to the issues above, it would appear the current Australian Financial Service License arrangements prohibit participants in a market acting as market makers unless they are licensed to do so (and arguably for good reason), it seems worth investigating what parties may be comfortable performing a market making role more commercially.

Forced participation of physical players seems contrary to appropriate risk allocation which is an underpinning driver of the NEM design and ignores the important role that financial intermediaries play in the market for derivatives. Likewise, the existing financial markets could be used to encourage parties to take upon market making obligations for a fee, as is the case in Singapore which deserves closer attention, where ENGIE also has trading operations and has a long involvement in market development in that region.

It should also be noted that the Singapore and New Zealand experiences differ from the NEM in that they were intended to encourage the launch of liquid markets which otherwise was not occurring. This differs from being implemented on the basis there needs to be a specific, if yet to be identified, level of liquidity within each region.

Interestingly, and as raised by other participants, the ASX is currently testing interest in market making as part of its ASX Market Making Incentive Scheme. Allowing that arrangement to develop based on voluntary participation is an important consideration. A compulsory impost may undermine the business case for those participants who were willingly able to provide such a service.

Conclusion

The ACCC rightly noted the concerns of some market participants in accessing hedges with the desired terms, without focusing on the legitimacy of these concerns, and with close attention given to South Australian trading outcomes where liquidity is lower. The consultation paper has examined the issues associated with implementing the proposed recommendation raised by the ACCC which is aligned with a broader obligation proposed as part of the National Energy Guarantee reliability obligation. Neither the reliability obligation, the status of which has been subject to some speculation as that process has changed, or the ACCC proposal, have gone through the full rule making consultation process with which most participants are familiar.

Therefore, ENGIE is in the process of lodging a rule change proposal with the Australian Energy Market Commission for a preferable approach to market making. This will look to build upon the important work of the ESB outlined in the consultation paper, and to enunciate the issues outlined by the ACCC in the Retail Report.

I trust this submission assists and thank the ESB for their continued efforts in assessing critical issues to support the energy transition.

Should you have any queries in relation to this submission, or the proposed rule change, please do not hesitate to contact me on, telephone, (03) 9617 8415.

Yours sincerely,

Jamie Lowe
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