



Friday, 19 October 2018

Dr Kerry Schott
Chair
Energy Security Board

Dear Dr Schott

RE: Market making requirements in the NEM

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Energy Security Board's (ESB) consultation paper on market making requirements in the National Electricity Market (NEM).

About ERM Power

ERM Power is an Australian energy company operating electricity sales, generation and energy solutions businesses. The Company has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load¹, with operations in every state and the Australian Capital Territory. A growing range of energy solutions products and services are being delivered, including lighting and energy efficiency software and data analytics, to the Company's existing and new customer base. The Company operates 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland.

www.ermpower.com.au

General Comments

In our submission on the National Energy Guarantee, ERM Power argued for the introduction of a well-designed Market Liquidity Obligation (MLO) as part of the reliability guarantee of the National Energy Guarantee ('the Guarantee'). The Australian Competition and Consumer Commission's (ACCC) final report into electricity prices has also recommended the introduction of market making requirements in South Australia in order to enhance retail market competition due to the low level of contract market liquidity.

ERM Power believes that market making obligations in South Australia make sense in the current environment given the low level of contract market liquidity in the South Australian market. We also remain convinced that an MLO associated with the reliability guarantee of the National Energy Guarantee is a necessary tool to help effectively counter the risk of economic withholding and to assist small retailers access contracts during times of tight supply-demand balance. Without this obligation, the competitive dynamics of the retail market could be undermined during periods of a reliability gap.

We have proposed a model where, outside of the National Energy Guarantee, a rolling two-year window would be used to assess the need for market making obligations. The obligation would trigger if liquidity fell below 1.5 times underlying electricity demand in a quarter and remain in place until two years of above-trigger liquidity has passed. Participants with a generation market share of 15 per cent or greater and the possession of a retail licence should be covered by the obligation.

¹ Based on ERM Power analysis of latest published financial information.



While the drivers of the ESB's Market Liquidity Obligation and the ACCC's market making recommendation are different, we believe the basic structure of both requirements should be complementary and consistent.

The submission that follows outlines ERM Power's responses to the questions posed by the ESB in the consultation paper.

Please contact me if you would like to discuss this submission further.

Yours sincerely,

[signed]

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As it is intended the MLO would be triggered in South Australia immediately (as per recommendation 7), how much time would participants need to prepare for the implementation of the obligation?

What products should be offered by obligated parties when the MLO is triggered by the liquidity test?

What process should be used to determine whether sufficient liquidity exists in a region to satisfy the liquidity test?

What period should be covered in the event of a liquidity trigger (e.g. two years from the commencement of the next quarter – the obligation triggers in May 20XX but commences and covers products from 1 July 20XX)?

It is intended the reliability and liquidity triggers would not result in materially different obligations, other than the timeframes the respective obligations apply. Are there circumstances that would require a different treatment between the triggers and/or resulting obligations?

How should both triggers interact?

What circumstances might necessitate a review of the MLO?

What factors should be considered for the liquidity test in relation to a market making obligation (e.g. the contract period that should be assessed for liquidity)?

How could the liquidity test apply to Tasmania?

ERM Power believes that the MLO could be implemented in South Australia relatively quickly, with a start date of 1 January 2019 for the trading of product from the third quarter of 2019 (1 July 2019 – 30 September 2019). This would give the parties required to make products available several months to prepare for the new requirements as well as allowing for lead time before having to make contracts available for the current quarter. Obligated parties should be required to make a relatively simple suite of products available to meet this requirement: flat swaps, peak swaps, and caps. We believe this provides a workable balance between ensuring contracts are made available as soon as possible, while allowing obligated parties time to adjust to having to make contracts available.

We consider that trading levels of 1.5 times underlying electricity consumption for each quarter provides a useful metric for assessing whether there is sufficient contract market liquidity. This level should exclude 'exchange for physical' (EFP trades where existing OTC contracts are converted into exchange traded products). EFP trades can appear at first glance to look like increased liquidity but in fact do not represent such.

In terms of how this liquidity obligation can apply in other regions should such a requirement develop, ERM Power considers that care has to be taken to avoid a situation where the requirement drops in and out or leads to a contracting 'cliff' where liquidity suddenly drops. For this reason, we believe that the requirements should apply for two years from the quarter to following initiation on a rolling basis. That is, as long as underlying liquidity remains below the trigger level – 1.5 times underlying quarterly consumption in our view – there should be a two year forward window where the obligation applies. This would mean that the obligation would not end until there had been two years of trading with levels above the trigger point.

Obviously, a different approach is needed in a gap period has been triggered under the reliability obligation of the National Energy Guarantee. In that case we believe that the MLO should only apply for the specific gap period, commencing when the gap period has been declared. However, if there is already a making-making provision in place we consider that it should take precedence, and that there is no need to implement a second requirement for the gap period.

The consultation paper asks about how the liquidity test could apply to Tasmania. There are already state government-imposed requirements for Hydro Tasmania to make contracts available to those seeking them.



Provided that these remain in place, ERM Power does not believe that market making requirements are needed in Tasmania.

Does the existence of both a generator and retail licence within related corporate groups adequately capture all large, vertically integrated retailers?

In addition to a minimum generation size threshold, should there be a minimum retailer size market share threshold? How could this be defined?

Which of the three broad methods to determine generation market share is appropriate?

Should the calculation of generator market share in a region be restricted to scheduled generation or should de-rated semi-scheduled generation also be included?

In addition to generator ownership, should access to trading rights also be used in the calculation of generator market share?

Are there other methods that should be considered to determine obligated participants?

ERM Power considers that the market already understands who the large vertically-integrated retailers are, and that the most transparent test is the possession of a retail licence and having generation registered with AEMO. However, we are not privy to the exact nature of every party's corporate structure to adequately understand whether this would in fact capture all vertically-integrated retailers.

We also believe that the ESB's proposed Option 2 of a 15 per cent generation share in a market provides the most suitable basis for imposing the requirements. These will certainly be large generators with the capability to make liquidity available if need be.

Thresholds for generator market share should be based on the registered capacity of scheduled generation. Considering methods such as the bidding of available capacity through AEMO's Projected Assessment of System Adequacy (PASA) process could lead to gaming where generators bid as unavailable to avoid obligations but then make capacity available at short notice.

The decision of whether or not to include access to trading rights is a complicated one as this access can take various forms, some of which provide participants greater levels of access to contracts than others. For this reason, ERM Power contends that this can only be done on a case-by-case basis.

Finally, we do not consider that retailer size threshold is necessary. It may in fact be counter-productive as a threshold expressed in terms of customer numbers or market share of load could provide an incentive to limit customer numbers and thereby avoid the obligation. This runs the risk of reducing retail competition in markets that may already have a lower level of competition.

Trading platform

Should alternatives to a centrally cleared platform for the MLO be considered?

Are the requirements for Hydro Tasmania under the Tasmanian Electricity Supply Industry Act 1995 adequate for meeting the MLO in Tasmania in the event the reliability requirement was triggered?

Trading volume, bid-offer spread, and limits

Should the volumes associated with quoting bids and offers on the MLO be specified as 5MW parcels? Is there a need for any exceptions? For example, smaller parcels (<5MW) more suited to the needs of smaller participants or new entrants?

Is a 5% spread appropriate? Could a tighter spread be justified?



Should the MLO operate only in the last half an hour of the trading day or should it extend beyond this window?

What should the requirements be regarding the refresh of prices once traded?

Should there be a limit on trade volume for a participant's obligation over a certain period? How should any limit be determined and over what period should it apply?

Should any limit vary by participant and/or region?

Safeguards

How could a trading halt or release of market sensitive information be recognised?

What process should be adopted to manage changes to market share calculation during the period of an obligation?

What process should be adopted for changes to obligated entities while the obligations are operating?

How should the obligation apply to entities who previously have not been subject to the obligation? What is an appropriate notice period?

Is it appropriate for the MLO to be satisfied through alternate, formalised market-making arrangements? Should there be any constraints?

How can the AER be satisfied that a participant is meeting its obligations under the MLO?

Is it appropriate for the AER to rely on third-party assurances such as that provided through alternate market making agreements?

Trading platform

While ERM Power considers that using centrally-cleared platforms will provide the most visible and transparent form of making liquidity available there are alternative approaches that can be used. In Western Australia, Synergy² and Alinta³ make details of their contracts available through online postings, while within the NEM Hydro Tasmania⁴ provides a similar service. This is a model that could perhaps be adapted more widely in the NEM.

As previously indicated, making market obligations are unnecessary in Tasmania provided the existing arrangements on Hydro Tasmania are maintained.

Trading volume, bid-offer spread, and limits

ERM Power recommends that obligated parties should be required to post 5 MW parcels as part of the MLO, but that other parties should be able to purchase in increments of 1 MW. This will help to support smaller participants and new entrants and therefore by extension support competition.

The ESB has recommended a bid-offer spread of 5 per cent in this consultation paper as well as in the detailed design of the National Energy Guarantee. Given the current state of the market, we believe that this may in fact be too large in some cases and too small in others. Instead, a more nuanced approach is necessary depending on the product. By way of example flat swaps for Q1 2019 in South Australia are trading around the \$140 mark (as of 15

² Synergy Wholesale Transactions, <http://wholesale.synergy.net.au/SitePages/Transactions.aspx>. Accessed 15 October 2018.

³ Alinta, Electricity Fixed Forward Products, <http://www.alintaenergyexchange.com.au/electricity-fixed-forward-trading/>. Accessed 15 October 2018.

⁴ Hydro Tasmania, Tasmanian Contract Prices, <https://www.hydro.com.au/clean-energy/tasmanian-contract-prices>. Accessed 17 October 2018.



October). A 5 per cent spread represents a \$7 spread. For peak swaps, the spread would be even higher in dollar terms based on current contract prices.

As such, we consider that the following approach should be taken depending on contract type:

- Flat swaps: the lesser of 5 per cent or \$2/MWh.
- Peak swaps: the lesser of 5 per cent or \$5/MWh
- Caps: 15 per cent.

We have proposed a higher spread for caps due to the fact that these are generally lower priced products and therefore a wider spread is likely to have a lower impact in dollar terms.

These products should be made available during the last half hour of the trading day as the ESB has suggested. Additionally, obligated parties should only be required to buy or sell 5 MW net in any quarter each day. That is, if their offer is accepted, their bid can remain in place without needing to post another offer. If the bid is then accepted, the obligated party would have essentially returned to their starting point and a new bid and a new offer should then be posted. This would help to keep the requirement somewhat limited in terms of net impact on the participant.

Safeguards

ERM Power considers that it is essential for trading halts and the release of market sensitive information to be recognised. These are events that can arise for any participant in the market. It would raise a troubling prospect if they were not respected as exceptional events that are necessary for the wider benefit of investment as a whole.

We consider that changes to obligated parties under the MLO should be through either an application from the participant to the AER to remove the requirement or a direction from the AER to a participant that they will be covered by the obligation. In both cases, the requirements should change at the end of the current quarter with a minimum notice period on both sides.

To some extent, changes to obligated parties can also be foreseen. The closure of a generator that may bring a participant below the 15 per cent threshold should be foreseen through the three-year notice of closure period that the AEMC is currently consulting on. On the other side, the construction of a generator will also be known well in advance, though the impact on market shares of various parties will be more complex to deduce and could take some time to better understand.

ERM Power believes that a single model for compliance is the most preferable approach but that should alternative arrangements be considered, these could also be assessed via approval from the AER. The AER also has a role to play in auditing reports from obligated parties to ensure that they are complying with their obligations. We consider that a quarterly, auditable report is an appropriate level of oversight. A case could be made for alternative approaches, but it would have to be robust and transparent to ensure compliance.