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Energy Security Board

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EnergyAustralia submission to Market Making Requirements

EnergyAustralia welcomes the opportunity to make a submission to the Energy Security Board's Market Liquidity Obligation Consultation Paper.

EnergyAustralia provides gas and electricity to 2.6 million household and business accounts across the National Electricity Market (NEM) with a diverse generation portfolio of coal, gas and renewable energy.

EnergyAustralia believes the case has not been made to warrant the need for the market making requirements as the NEM enjoys fairly high levels of liquidity in all regions, except South Australia which faces a number of structural issues inhibiting greater liquidity. Those South Australian specific issues include:

- The small size of the market, compared to other regions
- It is a very volatile physical market which is highly sensitive to weather patterns and single asset contingencies
- There is low accountability for market impacts when scheduling transmission outages and interconnector constraints
- There is significant market intervention by system operator.

These factors all contribute to the lack of liquidity and enforcing market making over the top of these issues will not paper over these structural problems. However, EnergyAustralia recognises the desire of policy makers to test market making and therefore does not oppose a sunset trial of market making obligations in South Australia only, reviewed after 2 years. If that review finds market liquidity has not genuinely improved, the obligations should cease in South Australia.

The rest of the NEM has ample liquidity, in fact Singapore introduced its market making requirements to try and achieve the kinds of liquidity we already have in the Australian market. The data shows that liquidity is not dropping, as shown in the chart below.

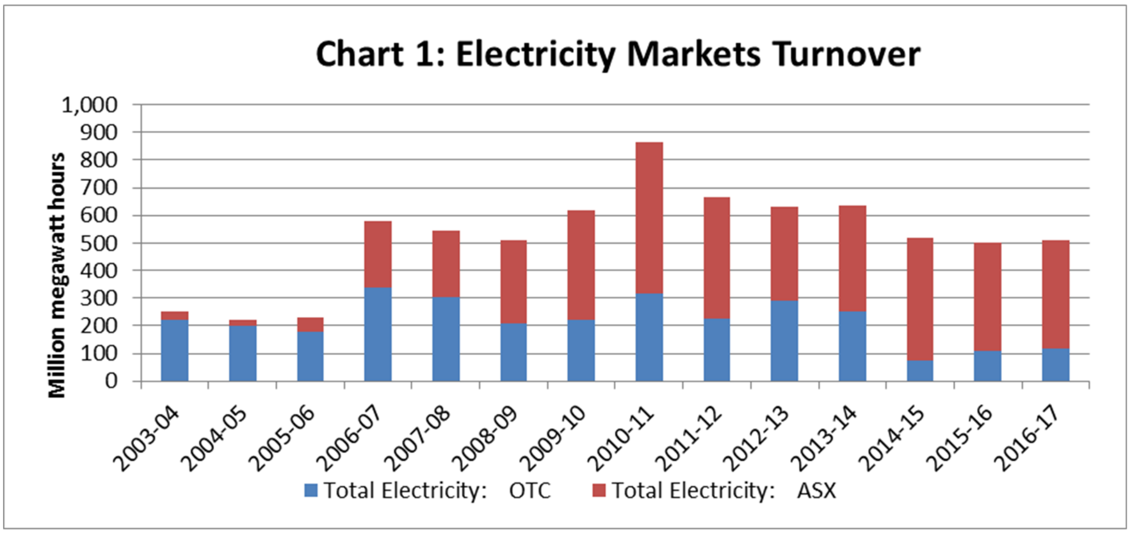

Figure 1. Source: AFMA Electricity Derivate Turnover Survey

We remain concerned about the effectiveness of market making based on evidence from overseas markets, which suggests such obligations are more likely to increase risks for market participants without increasing supply.

Countries which already have a market liquidity obligation (United Kingdom, New Zealand and Singapore) have had mixed results in the efficiency and effectiveness of the schemes. For example:

- in Singapore, market makers are paid to market make, but these payments have fluctuated as they are set via a tender process deteriorating desires to be a market maker.[1]
- in New Zealand, the regulator is considering the effectiveness of the scheme after market maker spreads widened during a period of tight supply. [2]
- likewise, in the United Kingdom, Ofgem has just reviewed aspects of their market making scheme after market makers complained of financial losses.[3]

These examples suggest that the superficial benefits of market making requirements are difficult to achieve, and that the measure is likely to create more problems than it solves. In this light, an underlying futures market liquidity problem needs to be clearly established prior to a market making requirements being imposed which can be made for South Australia, but not other jurisdictions in the NEM.

Importantly, the ASX is currently looking to introduce a voluntary market making in the Australian Electricity Futures, Caps & Options contracts market[4]. This voluntary mechanism is a far preferable way to explore any consideration of expanding market making obligations beyond SA as it provides the necessary flexibilities to ensure market makers are not locked into loss making positions by regulatory obligations.

As one of the largest traders on the ASX our concern about extending the market making obligations beyond South Australia, would be that we are less likely to trade on the ASX as we would be incentivised to reserve trades for compliance. This would therefore have the counter effect of lessening liquidity.

[1]https://www.ema.gov.sg/cmsmedia/Consultations/Electricity/Electricity%20Futures%20Market%20Consultation%20Paper_1%20Aug%202017.pdf
[2] https://ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2018/2017-winter-review/
[3] https://www.ofgem.gov.uk/publications-and-updates/secure-and-promote-review-consultation-changes-special-licence-condition
[4] https://www.asxenergy.com.au/newsroom/industry_news/market-making-expressions-of-

Application of the market making obligations to South Australia

EnergyAustralia believes that if market making is to be adopted, it should occur on a rolling 12 to 24 month quarterly contracting basis to align with the contracting requirements of the reliability obligations under the NEG. For example, market makers should be required to offer contracts for the quarter, 12 months in advance. This will incentivise advance contracting and aligns with the Reliability Obligation requirement on large customers to contract 12 months in advance. This will further incentivise contract to occur well in advance of physical requirements and reduce the ability for gaming by intermediaries.

The obligations should start mid-year, not during the summer peak where it has the potential to cause contracting issues during tighter market conditions.

The products offered by obligated parties should not be specified, rather the market participant should be able to tailor the total capacity of contracts offered based on their asset base. These contracts need to make sense with respect to the plant available. For example, forcing peaking generators to trade swap contracts creates financial exposure that may not be able to be managed at their short run marginal cost. Similarly, selling caps against generators with significant energy positions would be a poor fit relative to a swap.

The circumstances that might require a review of the market making requirements that we have identified (but there may be more) include:

- demonstrated financial loss as a direct result of the market making requirements. I.e. could set a threshold of maximum allowable loss;
- evidence of gaming of the market making requirements; and
- a retailer of last resort (ROLR) event.

EnergyAustralia is supportive of the simplest means of selecting obligated participants. This would be to set the number of participants to the three largest owners of generators within South Australia (inclusive of those with access to generation rights).

The other options would result in only two market makers in South Australia which would see less contracts being offered to the market, which goes against the purpose of the requirements.

Trading Arrangements

The trading platform should be agnostic and not entrench any one platform i.e. the ASX.

Market makers should be required to offer registered trades of a daily amount of 5MW or more. Trades should be capped to a maximum to be assessed based on the generation size of the region (i.e. total MW capacity), in this case South Australia, and based on the size of the market makers generation portfolio in that region. This would have the effect of ensuring a smaller market maker with less generation available, is not required to offer the same volume of contracts as a large market maker. The intent of limiting the daily trading volume is to reduce the risk of gaming an limit potential financial losses for the market maker.

The spread should be not less than $1, but up to 10%. This provides a threshold of materiality to ensure sufficient distance between the offer and the bid price so that market makers are not forced into loss making positions. If the spread is too narrow it risks becoming a barrier to new investment if power station owners know they may be forced to sell at loss making or even uncertain prices.

Forcing generation volumes to be sold at prices set by a defined spread significantly increases the risk of unprofitable investment. An example is that it obliges the market maker to trade at both “buy” and “sell” prices that can leave the market maker exposed. This occurs because during a large market rally the market maker is likely to get progressively shorter as buyers continually buy from them without anyone selling to them. The market maker would prefer to avoid selling anymore and so raises the price of their next offer. Having a defined maximum spread price comes with an obligation to buy at the bid price which is set by the offer price less the maximum spread. In a volatile market the market makers could end up buying back at prices, higher than those recently sold, leaving them in a loss position

It seems logical that market making trades be required to occur in the morning on the 2nd hour of the day for 30 minutes. This enables traders time to set their bids after arriving in the morning.

Provisions need to be made for trading halts when sensitive information is released. EnergyAustralia believes setting a threshold for levels of participation in market making is an appropriate way to deal with issues that may arise from by avoiding conflicts created by insider trading and uncertain asset availability. To account for this, we think a threshold of 80% daily participation should be set before any penalties apply.

For further information on any issues raised in this submission please contact Lisa Gooding, Team Leader Policy & Government Affairs, on (03) 8628 1467 or at lisa.gooding@energyaustralia.com.au.

Regards

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