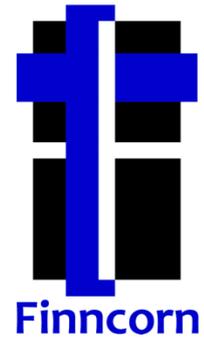


19th October 2018



Dear Energy Security Board

Market-making requirements in the NEM – response to Consultation Paper

We are pleased to provide our response to the ESB's consultation paper on the ACCC's recommendation number 7.

Finncorn acknowledges the support of Energy Consumers Australia in preparing this work – however, this submission is made on our own behalf.

We are at your disposal to discuss any aspects of this submission as the ESB proceeds with implementation of the ACCC's recommendations.

Yours sincerely,

David Heard

Finncorn Consulting

We are concerned at the apparent risks and unasked questions

While we appreciate the ACCC's data gathering and analysis and we understand they view this as a necessary and relatively simple step to take to enhance retail competition, we cannot agree at this stage.

To us, the proposal seems highly interventionist (in requiring established businesses to disturb their hedge strategies materially), somewhat arbitrary (in the way it is targeted to a certain class of participant), and with many fundamental questions which have occurred to us that seem not to have been even raised yet.

Reading the ACCC's final report, nor is clear that the effects would actually be in the best long-term interests of consumers, if it harms the incentives for lower-cost retailers to participate and compete, including by investing in new more appropriate forms of generation capacity. The market needs such investors.

Synthetic forced divestment seems a negative approach to take...

The basic problem we see is that (a) the ACCC agrees with us that vertical integration has benefits for costs; but (b) the obligation is a form of synthetic forced divestment of generation – via contracts, in slices, but nevertheless that is what it amounts to.

... should the focus be to deliver the same outcome more positively?

The ACCC cited our work on competitive structure in their final report¹, and noted that their more comprehensive data supported our hypothesis that a proliferation of small Tier 3 retailers may not support efficient competition, to drive Tier 1 retailers to compete with prices genuinely reflective of their relatively low costs.

The solution to this, in our view, is fewer but stronger challengers to the Tier 1s – and so rather than the proposed market liquidity approach, we urge the ESB to consider the converse: what positive steps could be taken to encourage a stronger cadre of tier 2 vertically integrated challengers?

Some alternatives

We suggest alternatives which are either more incentive-driven, simpler, or more comprehensive in addressing the issue – such as:

1. **Encourage the creation of new firm capacity outside the larger gentailers**, by requiring merchant renewable capacity to firm itself to some extent, and (as a natural consequence) increase hedge liquidity and decrease generator concentration.
2. **Use the NEG reliability mechanism permanently** – pull through new firmed capacity by that means. This would in practice drive the alternative above via retailer demand rather than regulation.
3. **Reconsider a less-draconian version of separation of gentailers**. Allow them to continue to hedge internally, but formalise the terms into “proper” hedge contracts, disclose to the trade repository, and most importantly, require the management incentives to be ring-fenced and Chinese-walled so that each side of the gentailer will seek best market pricing in pursuit of their own self-interest.

Devil in the details – questions yet to be asked?

In the body of this paper, we also highlight a fairly large number of “mere details” that do not appear to have been properly addressed in either the ACCC report or the ESB consultation paper. Many are fundamental. Taken together this looks to be very complicated!

¹ Refer to section 6.2.1 of the ACCC Retail Electricity Pricing Inquiry – Final Report, and our full submission available at: <http://energyconsumersaustralia.com.au/publication/state-play-quantifying-competitive-outcomes-retailing-nem/>

Care needed before this can be supported

We suspect that this recommendation is susceptible to unintended consequences which MIGHT not be in the best long-term interests of consumers.

The discussion paper implies the objective is to improve “*the ability of smaller retailers to capture market share from large, vertically integrated retailers*” with a presumption that this is in the long-term interests of consumers (via more effective competition in retailing).

It is not clear to us that the recommendation would actually lead to lower retailer costs and / or more effective competition to drive prices towards those costs.

This is because in our view, some (possibly most) small retailers do not really contribute to effective competition – they are too high cost, with little likelihood of ever gaining efficient scale due to a capital light business model. Barrier to entry are low, but barriers to efficient scale are very high – and not due to a lack of ASX hedge liquidity!

This is perfectly illustrated by the ACCC’s accurate description of how some small retailers are unhedged, underhedged, or are forced to use “expensive” OTC products because of their poor credit quality and related lack of capital to collateralise more efficient hedging obligations.

This recommendation will not alter the fundamental flaws in these business models.

Perhaps better to push the market the way it wants to go instead

The consultation paper also notes “*vertical integration reflects competitive advantages of the business structure, as a number of small and medium-sized retailers are vertically-integrated (or pursuing vertical integration)*”.

In our view it would be better to find ways to further ENCOURAGE the vertical integration efforts of smaller but potentially-competitive retailers – particularly via integration with new firming renewable capacity independent of the large gentailers – rather than try to contractually pull apart the existing portfolios in a form of **synthetic forced disposal of generation capacity**.

In our view there is enough turnover in generation capacity underway (thermal retirements and new-build renewables with associated firming) for a positive approach like this to have potential to succeed.

Valid objective – but other solutions may be less uncertain in their outcomes

In our opinion, the objective of driving greater liquidity in the hedge markets to encourage more efficient competition through to retailing is entirely appropriate – but this is a much more complex thing to achieve than it may have appeared.

We note that the concept is being framed to make the most basic traded products – quarterly baseload swaps and caps – more liquid.

At the same time, the ACCC has noted that small new-entrant retailers are more likely to either:

1. remain unhedged or underhedged, often because they do not have the capital to support hedge collateral rather than by choice, or
2. to seek simpler and less-risky load-following hedges from OTC counterparties – and to pay the appropriate premium – because they are too small to support the expertise to assemble a hedge book from the more basic products available from ASX (or OTC equivalents).

In the first case, retailers of this category are probably not adequately capitalised to add to efficient competitive outcomes. They will be high-cost due to low scale and high cost of capital. The proposed market-making will not change these constraints.

In the second case, note that if an OTC load-following hedge is available, the simpler equivalent product of OTC swaps and caps would almost certainly be available to these retailers as an alternative, if their preferences were different.

Given this, it seems to us that the proposed market-making is offering something which these retailers apparent do not prefer – so it is unclear how this is likely to enhance their businesses.

Given these fundamental issues, we think several other simpler, more positive and or more comprehensive approaches might be better to try first.

1. Add new independent firm supply, rather than redistribute the current firm supply

One alternative approach to reducing generation concentration (targeting the supply side directly) might be to require a (modest?) proportion of any merchant renewable generation held outside the large vertically-integrated gentailers to contract with new firming capacity in order to create a synthetic firm capacity asset.

The asset would then likely be offered into the hedge markets as a new source of liquidity, rather than the current situation of merchant renewable capacity taking the wholesale pool spot price.

This would create direct demand for the firming capacity – likely to be a good thing for reliability. The new synthetic dispatchable capacity would both decrease dispatchable generation concentration, and increase liquidity in firm hedging products.

Note that renewable capacity sold under a PPA has likely already achieved the desired objective: the PPA buyer will have firming the supply somehow, whether that buyer is a large gentailer (admittedly not assisting competition), a smaller retailer or a corporate load.

In the latter two cases, **new firm supply has met demand in a way which reduces concentration in generation**, when a slightly wider viewpoint is adopted as to the relevant generation market. The market is already finding commercial solutions.

2. Use the basic NEG mechanism a permanent obligation

We also note that a generalisation of the basic design of the NEG Reliability Mechanism might be a better approach to the above – which is clearly one interventionist approach replacing another.

It may be substantially simpler across both liquid and reliability objectives to create a permanent retailer obligation for firm contracting to an appropriate level. Perhaps this may be set at a lower level based on a liquidity objective in the absence of a declared reliability gap. This would drive contracting and firming investment from the demand side.

This would have the added benefit of simplifying the forecasting / triggering complexities of the NEG.

3. Commercial (not full functional) separation of gentailers

This is seeking a “have your cake and eat it too” solution, to largely preserve the benefits of vertical integration while removing many of the disbenefits.

We see merit in a requirement that allows vertically-integrated divisions to continue to hedge each other, but require this be done openly, via formal contracts equivalent to those with external hedge counterparties.

This would expose all liquidity via contracting at arms-length terms between any retailer and generator within a controlled corporate group, driven by **transparency and incentives**:

- **Transparency** would be via timely disclosure of the terms of all trades in the trade repository, regardless of whether internal or with outside corporate entities. The public data may be de-identified to some extent, but a governing body could audit the details privately.
- More importantly, **incentives** would be based on structuring remuneration for all staff in retail or generation to be only based on performance of their division, not the whole (similar to the incentives applicable in financial services organisations where ‘chinese walls’ apply). Managers acting rationally in their own interests would then only trade between divisions at arms-length terms, and so would have a good incentive to explore the terms available from others – driving increased liquidity.

Note that this is one step removed from the ACCC’s mooted model of “functional separation” which appears to suggest preventing gentailers trading internally altogether (although that is hard to envisage without a very rigid policy, given they presumably could and would trade with each other via ASX and OTC contracts if prevented from using more informal means).



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Commercial separation should be of no material concern to overall investors in (or lenders to) gentailers – merely ensuring that the way the economic benefits of the integrated businesses are split is independently divided. In this way, the many benefits of vertical integration (and the potential for those benefits to be passed through to consumers) are preserved.

This is the solution which most directly addresses the issue of concern, while (in our opinion) being least complex to design and administer, with least risk of unintended consequences.

All retailers and generators would have the opportunity to find each other and agree the most appropriate pricing for risk management – that sounds like a level playing-field.

Devil in the details

The target is stated to be “*large vertically-integrated retailers*” with a requirement to “*buy and sell specified hedge contracts each day*” (at a relatively narrow bid-offer spread).

This raises a few fundamental questions.

How does the obligation match the nature of the capacity (its cost or flexibility)?

Is potential medium-cost capacity treated the same as very high-cost oil or gas peaking?

If a holder of high-cost capacity was required to offer it at (say) \$150/MWh for a baseload swap that covers their costs, but therefore bid it at 5% less or \$142.50/MWh... presumably they are going to be left owning a lot of very high-priced swaps!

Equally, if an owner of a relatively inflexible baseload asset (say, a coal plant with poor ramping capability and / or a typical baseload operating profile with no capacity to increase generation beyond its rating) was required to make a market to sell \$300/MWh caps, they would wonder how they could physically defend those caps – but again, if they priced their offer high to reflect their risk, they would also need to bid high and again may be taken advantage of.

These are very fundamental questions which are not addressed. If they are addressed, the solutions may prove to be quite complicated, such as a bespoke obligation for each generation asset based on its presumed role in the market for supply of hedge contracts.

Who is the target here – big players, or just those who are net long generation?

Is this only intended to be targeted at “withheld” generation capacity – held within a gentailer who is net long firm capacity but doesn’t appear to wish to trade it?

Or would it also capture gentailers who may be large, but nevertheless are net short generation?

It seems to us that forcing a gentailer who is already short generation relative to their retail load (maybe holding 15% of generation but serving 30% of load in the region) will presumably drive them to retreat from any aggressive competition in the retail market, as well as any further generation investment.

This might raise churn and improve HHI scores, but it may not be the desired outcome for consumers if they are in fact an efficient lower-cost competitor than the alternatives.

Why are generators (or gentailers where generation is dominant) excluded?

If the objective is more hedge liquidity, why does the structure matter? How would this work in QLD where CS Energy and Stanwell are largely generators only (notwithstanding some small retailing by Stanwell)? Who would be left to be obligated if they were excluded?

Has Alinta placed itself in a position of obligation under its JV arrangements with CS Energy? If so, is that appropriate given Alinta is driving competition in QLD, not constraining it?

What capacity is included exactly?

It seems likely that the ESB will recognise that semi-scheduled capacity is not really able to offer swaps, let alone caps – so we presume only scheduled capacity will be considered.

What is “firm capacity”? Is it just anything thermal? What about firming capacity like a battery? What about a hydrogen turbine? What about a holder of firm demand response contracts?

Is it intended that the larger players with the lowest cost of capital be discouraged from investing in these newer forms of firm or firming capacity, on the basis they will simply be required to assist their competitors by being compelled to on-sell the benefits outside their own businesses?

What if the capacity is already sold (and might it be better if it was)?

Consider QLD where CS Energy and Alinta have entered into a large hedge arrangement for (we expect) several years. How would this obligation deal with that existing commitment?

Note also that this type of deal – where it can be done – may be a far better outcome for competition and consumers than having the same capacity dribbled out into hedge markets over a long period of time. The ACCC has clearly noted that vertical integration is the preferred business model, and the CS Energy – Alinta arrangement is a type of hybrid: a synthetic vertical integration.

This recommendation should not cut across or discourage those type of outcomes.

Is the obligation proportional to participant size?

If two or three entities are obligated, it may be that one has (say) 50% of capacity, another 10%. Are they each going to be required to make a market of 5MW each day? It seems problematic that the obligation may represent a much larger share of capacity for some – especially if that then constrains a small “challenger” retailer from growing their retail position as they are forced to sell off their internal hedge position.

How is OTC liquidity recognised?

The ACCC notes that smaller retailers make good use of OTC markets, partly because the capital requirements can be more manageable, partly because the structures available can be more suited to their preferences, such as load-following swaps.

It would be counterproductive if some obligated entities were supporting OTC liquidity, but withdrew this because of the obligation to offer ASX swaps and caps instead.

It seems to us that the obligation should fully incorporate OTC trades as a valid means to comply.

How do late-life assets comply fairly?

It is clear that over time, more thermal plant is becoming unreliable due to age or lack of investment, and may also be facing periods of marginal economics. These are likely to be the very plants underpinning a gentailer’s obligation in several regions.

A rational response to this would be to stop making long-term commitments such as 2-year forward hedges, with a view to potential closure. It doesn’t seem likely to us that (for example) AGL will be offering the full capacity of Liddell into the hedge markets as its closure date approached, for these reasons.

How can the obligation interact with this commercial reality, and the Finkel recommendation for 3 years notice? If a plant is uneconomic at whatever level of price the market determines it can sell swaps, how can it be required to continue doing so?

Is wash trading between the obligated gentailers OK – is transparency enough?

Are there any restrictions on the counterparties?

For example in SA region, could AGL sell to Engie, and AGL buy from Engie, so each maintains their desired net hedge exposure?

Perhaps the price discovery alone here is enough – others could presumably step in if they wished.

However, if this isn’t the intention, how would it be policed?