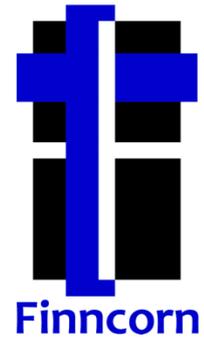


19th October 2018



Dear Energy Security Board

OTC Transparency 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 6.

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 support Recommendation 6, with some suggestions

We are broadly comfortable with the thrust of this recommendation, but we strongly suggest the ESB consider:

- (1) **The inclusion of Power Purchase Agreements (“PPAs”)** and similar long-dated derivatives which fall outside the more common definition of hedge contracts in the repository. PPAs should be included because they are long-dated OTC derivatives, either literally, or at least in all practical respects. PPAs markets are a key development in hedging for new capacity as well as retailers, and from an investor viewpoint they are key source of price discovery.
- (2) **Public data disclosure designed from the start to be forward-looking.** While traditional products such as baseload swaps, peak swaps, \$300/MWh caps remain key to hedge markets, they essentially correspond with thermal baseload, intermediate and peaking plant, and large-scale hydro. An understanding of the health of the contract markets of the future must consider the new breed of hedges designed for the transition underway in wholesale and retail: derivatives tailored to solar shape, wind intermittency, firming via different storage assets, and demand response products. In our view, it will be the emergence and growth (or otherwise) of these products which will be the more important indicator of a healthy functioning contract market as thermal capacity declines over time.

Transparency serves the long-term interest of consumers

Better policy and regulatory choices

Clearer understanding of the traded markets in electricity price risk should lead to better understanding by many stakeholders (whether examined in finer detail by the AER, AEMO and ACCC, or at a higher level by public stakeholders using the de-identified data).

This should lead to future policy and regulatory development in favour of strengthening the liquidity of those markets.

Lower costs may result from any interventions

Low frictional costs associated with well-functioning electricity risk markets are in the long-term interests of consumers.

They allow a wide range of competitors to operate effectively and at low cost to manage their exposures on behalf of electricity consumers, increasing the effectiveness of competition.

Any deficiencies identified as a result of this recommendation may lead to better-considered policy interventions to support this outcome, thanks to the evidence it will provide.¹

A first step towards a “mild” accounting separation of gentailers

We concur with the ACCC’s view that consumers’ interest may be best served by preserving the low-cost advantages of vertically-integrated gentailers, while pushing back against the potential distortions this structure may cause (including taking necessary steps to ensure competition becomes more effective to allow low-cost retailer positions to be translated through to lower prices).

These include:

1. **The advertent or inadvertent mispricing of the wholesale cost of supply of their retail businesses** (which may lead to competitive distortions in either direction – either a lack of retail competitiveness leading to higher-than-otherwise pricing, or an overly-competitive behaviour leading to overly-difficult conditions for retail competitors); and

¹ We note that this recommendation should perhaps be prioritised over more risky and interventionist steps such as the proposed liquidity obligation. Generally speaking, it seems to us it would be better to first understand the situation more clearly in each NEM region, prior to deciding such steps are likely to lead to more benefits than costs. We address this in our submission on the proposed market liquidity obligation.

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2. **The structural inability of competitors to access hedging from either side of the retail or generation businesses.** This can undermine an effectively competitive market if competitors are unable to manage risk in the most appropriate manner.

Transparency provided by trade reporting as proposed may prove to be a useful first step towards an accounting separation of retail from generation among vertically-integrated businesses. Our version of this is a relatively low-key, incentive-based version which would preserve much or all of the benefits of the structure. In short:

- **An arms-length internal transfer price based on market-equivalent hedge levels** and the ability (but not compulsion) for each division to hedge externally should that offer the most attractive terms available. In either case, the terms of the hedge contracts would be formalised, documented and reported allowing regulators to assess transfer pricing behaviour routinely; and
- **Strict ring-fencing of the incentives for retail and generation executives** to reflect only the performance of their division, rather than the whole gentailer. This should create a very clear incentive structure to ensure vertically-integrated hedging only occurs when the price is “at market” – and if it is, other retailers and generators should have a clear opportunity to be that best bid or offer.

Reporting of OTC trades assists both of these objectives, by providing more information to both gentailer and non-gentailer counterparties to better-establish a more liquid OTC market, and by providing a means of verification to a regulator that internal hedging is undertaken at arms-length terms.

OTC markets pioneer the most appropriate hedges – especially now

We agree that transparency driven by this proposal is likely to support greater participation in OTC hedge markets by retailers and generators.

We think this is essential now and in future, because the ASX-traded products are standardised and rigid, and (based as they are on a “baseload” futures product and “peaking” cap product suited to dispatchable thermal plant) they are not necessarily the “right” product for lowest-cost retailer or generator risk management as the nature of the generation fleet evolves, and given the particular preferences and constraints applying to smaller retailers seeking to compete.

This is especially true as the generation fleet moves towards greater intermittent supply. It is likely that the more flexible and bespoke OTC markets are where the new breed of hedges will be developed and refined – including:

- solar shape products;
- wind intermittency products;
- products designed to capture the capability of particular storage assets to offer firming within their technical constraints;
- demand response related options; and
- the firming structures likely to be needed to support direct corporate renewable PPAs.

We expect that as both the underlying asset bases and the OTC products mature, the ASX will eventually adopt the winning structures as new products – but that is uncertain. In the meantime, **effective hedging is likely to increasingly depend on OTC structures.**

Note that in our view this absolutely includes PPAs, which are in fact a long-term OTC hedge. In some cases PPAs can be legally structured as a contract for difference, like any other OTC hedge – and perhaps even transacted under an ISDA. They may also include a range of different structural characteristics of risk transfer. **PPAs are a very important means of price discovery for longer-term supply investment and for retailers establishing stable long-term wholesale hedges.**

While the re-introduction of the AFMA report provide some insight into shorter-term OTC hedge activity, PPA-derived insights are entirely based on hearsay.

Finncorn recommends that the ESB design the OTC Transparency obligation to include PPAs and similar long-term derivatives

A centralised fit-for-purpose repository via AER is likely the best approach

OTC electricity derivatives are relatively unique and complex among derivatives in general (or even among commodity derivatives) because of the particular features of the electricity market's risks.

In addition, we have highlighted above why we believe the electricity hedge contract market is likely to become substantially more complex over the medium term.

Therefore, we think a single, specialist repository is likely to be more appropriate than dispersing the data among existing generalist repositories. For the results to be useful, the repository will need to develop quite narrow expertise in understanding and capturing the data, which is likely to be evolving quite quickly. This is likely to be achieved at lowest-cost by a single specialist.

We agree that the AER seems best-placed to offer the necessary existing expertise to administer this function, as well as benefitting from direct access to the data to support its other role and proposed roles.

Reporting confidentiality and usefulness issues will be challenging

The issues raised in relation to confidentiality are very important and we expect that a reasonable outcome will acknowledge this by heavily protecting confidentiality, at some expense to transparency for the public stakeholders.

The nature and level of a counterparty's hedges are highly-sensitive, not only in terms of general competitive intelligence, but also because the nature of a traded market leads to risks of such information being directly exploited – “cornering the market” or similar behaviour by traders to exploit a competitor.

This is especially the case in electricity markets. Some counterparties benefit from physical asset positions, the ability to impact on network constraints, and far greater access to real-time information (including their own behaviour and intentions). All of these can place their competitors in a vulnerable position. Some of the recent Queensland generator behaviours appear to have highlighted this risk.

We have some sympathy with a closer restriction of the full data to AER only, for this reason.

In addition, the bespoke and evolving nature of OTC electricity derivatives – especially the emergence of non-standard volume terms such as load-following retailer hedges, solar shape, wind intermittency and demand response – may mean that useful general information is challenging to deliver publicly.

There may be a risk of misinterpretation if overly-simple metrics (such as MWh of volume hedged at a price) are used to accumulate deidentified data which is too diverse - details of the other terms (such as shape, interruptibility) will have a very significant impact on the price.

So - we expect that individual trade reporting in any public way will offer too many competitive concerns, but note that aggregated trade reporting will have different challenges in ensuring the aggregated data is meaningful while also grouped in large enough buckets to ensure retailer or generator exposures cannot be deduced by well-informed participants.

For these reasons, public stakeholders may need to be realistic about the level of useful public detail which will result. As a corollary, there is likely to be a need for skilled analysis and interpretation of the full confidential data set if the most useful conclusions about the health of the evolving contract market are to be drawn.

Mindful of these constraints, Finnorn recommends that the ESB collect and presented public data in categories which reflect small retailer needs, as well as the new type of generation and the associated specific hedge products which suit those assets – so in addition to baseload swap, peak swap and \$300 cap products or similar OTC versions, also (1) solar shape hedges (2) wind intermittency hedges (3) demand-response options (4) storage options and (5) load-following retail hedges.