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Energy Security Board
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Market Making Requirements in the NEM Consultation Paper

Snowy Hydro Limited welcomes the opportunity to comment on matters raised in the Consultation Paper from the Energy Security Board (ESB) on the Market Making Requirements in the NEM.

Snowy Hydro Limited is a producer, supplier, trader and retailer of energy in the National Electricity Market ('NEM') and a leading provider of risk management financial hedge contracts. We are an integrated energy company with more than 5,500 megawatts (MW) of generating capacity. We are one of Australia's largest renewable generators, the third largest generator by capacity and the fourth largest retailer in the NEM through our award-winning retail energy companies - Red Energy and Lumo Energy.

Snowy Hydro does not support the proposal from the ESB to manage concerns about liquidity in the market. The market making requirements such as the Market Liquidity Obligation (MLO) will impose potentially very large trading risk on these entities with no improvement on reliability. The NEM does need further market intrusion. The MLO if implemented across the NEM, would be ineffective and clearly misguided with the obligation likely to encourage financial misbehavior by participants trying to exploit competitors' enforced buy/sell market making obligations.

The identification of any competition issues should correctly be addressed by the Australian Competition and Consumer Commission (ACCC). The market making requirements will not achieve the intended outcomes the ACCC has identified. A recently commissioned paper by NERA Economic Consulting on the 'International Experience of Vertical Integration in the Electricity Sector' noted that implementing such measures in Britain and New Zealand had not increased either liquidity or competition but merely shifted them into regulated products. The additional regulation likely depressing liquidity[1].

Market Making Requirements

Snowy Hydro opposes the market making requirements such as the MLO as it will impose potentially very large trading risk with no improvement on reliability. The MLO would add to market uncertainty by singling out particular market participants for action in response to perceived competition shortcomings. We believe large vertically integrated retailers that are required to support market liquidity for the period of the gap will not physically increase supply and ensure the reliability of the NEM.

The market making requirements will not achieve the intended outcomes the ACCC has identified.

[1] NERA Economic Consulting, 2017, "International Experience of Vertical Integration in the Electricity Sector"

We are concerned that any market making requirements will provide a further obligation on market participants to provide market liquidity making it in the process more difficult to meet.

The ESB consultation paper correctly notes that *"there is extensive trading and re-trading of energy in all except South Australia, where trading levels are well below the overall energy demand"*[2]. Although it is true that the volume of swap products traded is less than other regions in South Australia the consultation paper fails to mention is that it is a small state in comparison to NSW and Victoria with a relatively small peak demand that is largely oversupplied. In addition, wind output is constrained back at times in South Australia as there are not enough gas generators in the system under AEMO's new guidelines further reducing the liquidity in the market[3].

Only recently, plans were released in South Australia to increase interconnection by 800MW with the commissioning of the RiverLink project sometime between 2022 and 2024 likely lowering generation dispatch costs in South Australia[4]. A recent report by ElectraNet suggests that it would result in the wholesale price of electricity reducing in South Australia as soon as interconnection is established. It will also result in a reduction in gas consumption for power generation in South Australia, freeing up gas for other uses. The interconnection options between South Australia and NSW provides a benefit through being able to avoid the intra-regional transmission costs that AEMO estimates in the ISP that would otherwise be required to unlock additional renewable generation resources in the Murray River and Riverland REZs[5].

As noted above, the AFMR survey shows that the number of trades in the NEM has continued to increase (Figure 1), OTC turnover in 2016-17 was 23% of total market turnover with aggregate turnover in all products (both OTC and ASX) in 2016-2017 greater than the NEM System Demand by a factor of 2.8. There are numerous power purchase agreements, options and other bespoke contracts between counterparties which can be used to match supply to demand, and mitigate physical and/or financial risk in the NEM which are not mentioned in the consultation paper. The market making arrangements appear to be its focusing on "vanilla" products that may act to stifle product innovation, and reduce opportunities to provide the best possible products to the market.

Figure 1: Number of trades, daily average, ASX & Chi-X[6]

[2] Energy Security Board (ESB), 2018, "Market Making Requirements in the NEM – ESB Consultation Paper", pp7

[3] RenewEconomy, *"Wind output constrained in South Australia as it blows above 1200MW"*, << https://reneweconomy.com.au/wind-output-constrained-in-south-australia-as-it-blows-above-1200mw-20078/ >>

[4] ElectraNet, 2018, "South Australia Energy Transformation RIT-T Project Assessment Draft Report Summary", << https://www.aemo.com.au/-/media/Files/Stakeholder_Consultation/Consultations/NSP_Consultations/2018/South-Australia-Energy-Transformation---RIT-T-PADR-summary.pdf >>

[5] ElectraNet, 2018, "South Australia Energy Transformation RIT-T Project Assessment Draft Report Summary", << https://www.aemo.com.au/-/media/Files/Stakeholder_Consultation/Consultations/NSP_Consultations/2018/South-Australia-Energy-Transformation---RIT-T-PADR-summary.pdf >>

[6] AFMA, 2018, "2017 Australian Financial Markets Report", << https://afma.com.au/data/afmr/2017%20AUSTRALIAN%20FINANCIAL%20MARKETS%20REPORT.pdf >>

Market Making Requirements if implemented would be ineffective and clearly misguided. There is no exact amount of unused capacity that can be conjured up by regulation. It is unclear with energy limited generators what the opportunity cost of their generation may be. Hence suggestions of forcing the entity to post tight bid/offer swaps up to its registered capacity is inefficient when the opportunity cost of these energy limited plant changing all the time. The MLO requirement would simply increase risk to the gentailer which ultimately is passed through to consumers. It also risks inefficient use and misallocation of scarce resources for fuel-constrained plant, again worsening consumer outcomes.

Snowy Hydro highlights similar issues with the efficient pricing of tight bid/offer spreads for Combined Cycle Gas Turbines (CCGT) and Open Cycle Gas Turbines (OCGT) where access to gas and transportation becomes a real issue to efficient pricing.

Snowy Hydro notes that wide bid/offers are reflective of taking a position in what may be a high risk and/or highly uncertain in regions. Therefore, if the MLO imposes tight bid/offer spreads then this fundamentally increases the risk of participants who will have this obligation. This raises questions, of what are the unintended consequences of such a position? Will it enable speculative misbehavior from those participants and/or speculators who don't have this market making obligation?

The MLO if implemented would be ineffective and clearly misguided. When the NEM supply/demand balance is tight, there is no unused capacity that can be conjured up by regulation. The proposal is only likely to encourage financial misbehavior by participants trying to exploit competitors' enforced buy/sell market making obligations.

Relevance of Other Jurisdictions for MLO

The ESB notes that the MLO promotes transparency, liquidity and provides access to qualifying contracts. Snowy Hydro believe that care must be taken in making comparisons to the rest of the world or to non-NEM states which are very different markets and whose mechanisms are not necessarily providing the outcomes they were intended to provide.

A recently commissioned paper by NERA Economic Consulting[7] on the International Experience of Vertical Integration in the Electricity Sector noted that forcing vertically integrated firms to trade like standalone businesses has little or no impact on liquidity. The report noted that implementing such measures in Britain and New Zealand had not increased either liquidity or competition but merely shifted them into regulated products. The additional regulation likely depressing liquidity.

The Irish regulators considered forcing large electricity firms to trade in short-term contract markets to promote liquidity, however, the NERA report highlighted respondents to the consultation presented evidence that such policies would harm competition, in this case by increasing the deficits of the companies affected and exposing them even further to anticompetitive action. The Irish regulators have held back from imposing a trading obligation, pending observation of how new market arrangements will work.

In the United Kingdom the equivalent to the MLO has brought some benefits to the market, however, these benefits have come at the cost of a subset of market participants while the established smaller players are finding it hard to compete[8]. Five market participants in the United

[7] NERA Economic Consulting, 2017, "International Experience of Vertical Integration in the Electricity Sector"

[8] Andrews, A, 2017, "Is the Secure and Promote liquidity fix fit for purpose?", << https://www.newpower.info/2017/04/is-the-secure-and-promote-liquidity-fix-fit-for-purpose/ >>

Kingdom are required to cross-subsidise their competitors' risk management activity at an annual cost of some £20 million[9]. We believe more extensive analysis is required if there is to be any comparison to international experiences.

The Western Australian example is very different to the NEM and care must be taken in making any comparisons between the two. The Wholesale Electricity Market (WEM) has a capacity mechanism and is not an energy-only market. The market demographic is also very different in the WEM as the continued dominance of Synergy in the WEM means that market power remains a headline concern in the market compared to the NEM where there are numerous vertically-integrated businesses operating. Across the NEM, market concentration is also likely to diminish further with the growth of renewables and the closure of Liddell.

Snowy Hydro appreciates the opportunity to respond to the Consultation Papers. Any questions about this submission should be addressed to Panos Priftakis, Regulation Manager, by e-mail to panos.priftakis@snowyhydro.com.au.

Yours sincerely,

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[9] RWE, 2017, *"Secure and Promote Review: Response to Consultation"*