Mr John Pierce
Chairman, Australian Energy Market Commission
Level 6, 201 Elizabeth Street
Sydney NSW 2000

25 October 2018

Dear Mr Pierce,

Rule change proposal: Market making arrangements in the NEM

I am writing to formally request that the Australian Energy Market Commission (AEMC) initiate a National Electricity Rule (NER) change process to assess the benefits of introducing market making in the National Energy Market (NEM) as per the attached proposal.

This NER change proposal arises in the context of the recent Australian Competition and Consumer Commission's (ACCC) Retail Electricity Pricing Inquiry - Final Report recommendation 7, and as articulated for potential implementation by the Energy Security Board in its consultation paper of September 2018.

ENGIE experience

ENGIE in Australia & New Zealand (ENGIE) has significant experience in the NEM as both an active provider and procurer of hedges whilst undertaking major portfolio changes. Internationally, ENGIE has drawn on the experiences of the wider ENGIE Group in Europe and Asia, which is actively involved in the development and operation of market making arrangements.

Rationale for the proposal

Based on ENGIE's experience, it is apparent that several fundamental questions around the justification for market making obligations, either in South Australia or more broadly, have not been adequately addressed. Introducing a requirement that will force specific market participants with physical generation to buy and sell contracts they would be unwilling to trade freely, due to a lack of financial incentives and additional risk exposure, is a significant change in the operation of the NEM. These changes may also conflict with existing laws covering the provision of financial services.

In order to enable further detailed consideration of market making, ENGIE has opted to lodge this NER change proposal with the AEMC. Further, based on ENGIE's analysis within the time available, an alternative approach has been proposed that seeks to manage the issues identified but not addressed in the ACCC or ESB's work. ENGIE trusts that these matters can also be further considered by the AEMC during the NER change process.

Benefits of the proposal

The attached proposal, if implemented, will have the effect of resolving many of the concerns ENGIE has identified with market making and promote ongoing confidence in the NEM and closely related energy markets (i.e. gas and LGCs) consistent with the National Electricity Objective as set out below.

- An economically efficient allocation of risk occurs between parties in the NEM (and related markets) including management of new entrant retailers without placing unmanageable risk on selected physical participants.
- Commercial drivers underpinning individual market participant hedge positions and trade in risk management instruments are not distorted.
- Services that are provided outside the normal course of market conditions are provided in a transparent manner with appropriate cost recovery.
- Shareholders and investors' expectations are not undermined by potential compulsory market making obligations so as to avoid placing a further risk premium on investment in specific or all regions of the NEM to account for unmanageable risk and unrecoverable costs.
- Encourage entrance of specialist providers who may be better placed to support market making services.
- Minimise the potential for entities to provide financial risk management services beyond their capability to do so (e.g. obligations to provide hedges that exceed the financial capability of the underlying generation asset).

I look forward to the AEMC giving this matter detailed consideration over the coming period and to further detailed consultation with relevant stakeholders.

Additionally, given the complexity of this matter, this proposal does not provide proposed drafting of the NER, and seeks further engagement with the AEMC on this element at the appropriate time.

Should you have any queries in relation to the attached proposal please do not hesitate to contact me on, telephone, (03) 9617 8415.

Yours sincerely,

Jamie Lowe
Head of Regulation

Rule change proposal: Market making arrangements in the NEM

This paper sets out ENGIE in Australia & New Zealand's (ENGIE) National Electricity Rules (NER) change proposal for the introduction of market making arrangements in the National Electricity Market (NEM).

1. Background

The Australian Competition and Consumer Commission's (ACCC) Retail Electricity Pricing Inquiry - Final Report (ACCC Retail Report) represented an important check on the health of the retail market and aspects of the NEM, and developed a detailed set of recommendations.

To date, much of the work of the ACCC has been well received by governments, industry, and consumer groups. Like many market participants, ENGIE welcomed the ACCC's work and supports the intent of the recommendations.

In the Energy Security Board's (ESB) final detailed design of the National Energy Guarantee (NEG) a market liquidity obligation "was proposed to promote liquidity, transparency and competition in the event the Reliability Obligation is triggered"[i]. This arrangement was primarily driven by a set of concerns arising from the obligation on retailers and large customers to contract under specific market conditions not being able to contract to meet those obligations.

These two streams of work were combined into one in the ESB's consultation paper: market making requirements in the NEM, September 2018 (ESB Consultation Paper).

2. Identifying the problem

ENGIE does not dispute that some retailers may have difficulty gaining contracts of the duration, granularity, or price they would prefer. Likewise, many generators and hedge providers are unable to find purchasers for hedges at the price, granularity, and duration they desire. Neither necessarily suggests a market failure.

ENGIE does dispute the value of compulsory market making as the solution for South Australian market conditions and does not believe the case has been well made that vertical integration is the primary, or even a significant contributor, to the challenges faced by market participants on both sides of the market in South Australia.

<u>South Australia</u>

As a business with ongoing operations in South Australia, ENGIE does not believe the justifications outlined in the ACCC Retail Report are sufficient. Raising a concern that small retailers may have difficulty contracting in the manner they prefer does not of itself make that concern valid or necessitate action. Especially action in a form that shifts risk to parties who would be obligated to contract outside their existing risk appetite.

The analysis in the ACCC Retail Report assesses the competitiveness of the South Australian market against two primary benchmarks. First, the ability of small retailers of unspecified financial viability to obtain contracts at the price, granularity, and of the duration that they desire. Second, contract liquidity of the smaller South Australian region against the larger regions. The conclusion in this context, and set against the spectre of vertical integration, suggests that market making obligations is the solution. This is despite the acknowledgement prices for trades of bigger and smaller participants in South Australia were largely the same.

ENGIE does not support the ACCC Retail Report's assessment because it has not effectively diagnosed the South Australian market conditions nor made a link to conclude market making as proposed will solve the challenges some suggest are present in South Australia. While the consultation paper provides a more detailed analysis of the characteristics of market making, it was not drafted with the intention of assessing the ACCC Retail Report conclusion or providing more detailed evidence. In ENGIE's view, a more detailed analysis of the problem and proposed solutions is still required.

This means the primary issue, South Australian market outcomes compared with other jurisdictions remains insufficiently discussed with a weak evidence base to support market making as an actual or preferred solution.

Hedging in South Australia

Hedging in the South Australian market needs to be assessed in comparison to other jurisdictions on the basis of its unique characteristics: a small market with a high penetration of renewables, reliant on gas generation to provide firmness, and with important inter-connection with Victoria.

The implication that can be taken from the ESB Consultation Paper and the ACCC Retail Report seems to be that vertical integration provides internalised risk management services across the integrated company which results in vertically integrated electricity companies withholding hedge products from competing retailers. That is, that they have the capacity to provide additional hedges but choose not to do so even at the cost of not entering hedges at all. There is little evidence, if any, that this is the case, especially in circumstances where prices are or could be rising.

Further, gas generation is unlike baseload coal-fired generation and assessing all large generators in a similar manner lacks sophistication and appreciation of the specific, significant issues that gas fired generation faces with respect to gas market liquidity.

Gas market dynamics

Unlike coal-fired generation, gas generators are driven by the dynamics of the underlying and less flexible gas market both in terms of liquidity and granularity of contracts. Willingness to contract is driven by gas positions and gas supply in a way that fundamentally differs from baseload coal operations.

The lack of gas market liquidity in terms of the ability to enter and exit positions, the granularity of contracts, the tenure of contracts and the lack of standardisation of contracts has a direct impact on the liquidity of electricity contracts. Fundamentally a gas fired generator is a device that converts gas into electricity.

Unlike non-export black coal or brown coal, which is best utilised as fuel for generation, a gas position may be better utilised to meet retail demand, delivered to large users directly, taken to other markets, or not taken so as to on sell pipeline transportation.

Therefore, in such a complicated market, where a decision to generate with gas cannot be assumed, expecting gas-fired generators to provide the same level of liquidity as coal-fired generators in the larger regions is mistaken. This issue was not adequately addressed in the ACCC Retail Report or in the ESB Consultation Paper.

Notably, while reference has been made to the United Kingdom scheme, generators in the United Kingdom scheme of market making can rely on a very dynamic and liquid gas market which differs from Australian arrangements. This includes for South Australia.

Experience of firm generators in South Australia

Further, the recent history of South Australia shows that interest in contracting with physical participants is mixed, which contrasts with the ACCC Retail Report conclusions and the intent of the ESB Consultation Paper.

It is well understood that significant effort was made by the last operating, now closed, coal-fired generator to contract with customers before closing. Similar efforts were made and the absence of parties willing to contract was noted, with respect to Pelican Point Power Station before that plant was withdrawn from the market. It has since returned.

The fact is that customers, including small retailers were very willing to 'ride' the spot market on the expectation prices would remain supressed and new renewables and gas fired generators with loss-making, must-run, take-or-pay contracts would maintain this downward pressure. Only with changes to firm generation, that were rational and appropriate for the affected parties, have unhedged participants come to regret their decisions as volatility increased. This is not a failing in the market but a failing in customers' contracting strategies. Volatility is now encouraging greater contracting, which is how the NEM is expected to function.

Notably, one of the drivers of the NEG reliability obligations was to encourage large customers to contract where it was clear an absence of contracts, including in South Australia, has led to generators closing or being mothballed when they were in fact needed in the market for security of supply. But the market making discussion has somewhat turned this argument around whereby now a perceived problem with vertical integration and contract withholding, without evidence, is seen as the most critical driver of lower liquidity in South Australia.

Interestingly, in its current deliberations on the future of the United Kingdom scheme, Ofgem[ii] has acknowledged that the finding by the Competition and Markets Authority[iii] that they "have not identified any areas in which vertical integration is likely to have a detrimental impact on competition for independent suppliers and generators". This is, in turn, an important consideration in determining whether the special licence conditions which mandate participation in market making should be withdrawn.

Further, smaller retailers having trouble hedging at the desired price, granularity, and duration is not of itself a market failing. Especially if those small retailers are not financially capable of managing the risk needed to trade or desire below market priced trades. A barrier is problematic if it is an artificial constraint, not if it is a legitimate cost of doing business that an inexperienced party cannot manage. Again, with reference to the United Kingdom, an alternative policy for small market participants, and not market making was developed to support the challenges raised in the ACCC Retail Report.

3. Concerns with market making requirements as outlined by ACCC and ESB

This section reiterates concerns with the ACCC Retail Report and ESB Consultation Paper proposals.

Market making obligations likely to create several challenges

If the intention is to try and shift risk from one party away to another, for the benefit of small purchasers only, and without reference to impacts on risk allocation, then perhaps a market making obligation as conceived to date could be a partially effective, albeit blunt, instrument. But such an outcome will have obvious consequences which have not had an opportunity to be considered and may not be in the long-term interests of consumers.

Changes won't necessarily improve risk management and trading

Firstly, it cannot effectively change the total capacity to manage risk in the market. This means when an obligated party is forced to take on one form of risk they do not have an appetite, or ability, to hold, they will need to rebalance their operations or contracting in other areas to maintain a similar overall risk exposure.

For example, an obligated party may change its internal risk management approach, allocating more hedge contracts to the traded market even if its related retailer then bids into the traded market for hedges previously provided internally. This will lead to a loss of efficiency, but unless anti-competitive withholding is occurring, the total supply of risk management instruments should not change. In addition, if the obligated participant is unable to manage the additional risk either through buy back or matching gas contracting, the participant could become exposed to market and credit risk beyond their desire and capability to manage this exposure.

This is consistent with findings in the United Kingdom and New Zealand market making schemes, where the increase in liquidity occurring within the trading windows appears to be accompanied by declines in liquidity outside the trading window. Similarly, improvement in the liquidity of specific mandated instruments appears to have been achieved at the expense of lower liquidity in other previously traded instruments.

In the United Kingdom in particular, ENGIE's experience is that liquidity inside the trading windows did not greatly assist small participants who remain reliant on arrangements with larger players. Those larger players now need to engage a small team of traders who are dedicated to managing the risk associated with the mandated trading window. When a mandated offer is 'lifted', the affected player then instantly seeks to 'hit' another mandated player's offer to manage the risk (i.e. close out the position). This has under some circumstances increased volatility, cost (e.g. by crossing the spread to close position) and risk.

Importantly, the ability for a mandated player to close out the position in the South Australian market is likely to be substantially less than in the United Kingdom market, leaving the mandated party with an unmanageable risk position.

Notably, while the overseas market making obligations were cited in the ACCC Retail Report, little attention was given to the worth of those schemes or their general health, and the general market characteristics and constraints under which they operate. The ENGIE Group's operations in Europe suggest that the scheme in the United Kingdom is being reassessed given problems that have arisen. ENGIE understands the scheme may be suspended as early as November 2018[iv].

Credit quality cannot be ignored

Second, market making may change access for contracting parties, but to the extent that access is provided to contracting parties with lower credit quality, it will not eliminate the costs of lower credit quality. The costs of lower credit quality flow from the higher risk of a loss given default or failure by a low rated counterparty relative to a counterparty with higher credit quality. Increasing an obligated party's exposure to lower credit quality counterparties inconsistent with its risk appetite is likely to result in higher costs to all customers.

If market making is implemented through exchange traded contracts, both parties to a transaction incur higher working capital costs through the application of margins to exchange participants. If implemented through over the counter (OTC) derivatives, the cost to the provider are managed through rationing trades with counterparties according to their credit worthiness, or providing for margins, or both.

The United Kingdom market making scheme separately provided for common documentation – ISDA Agreements used widely across the Australian market being similar – but allowed for different treatment of counterparties. Such an arrangement would be needed in Australia to manage risk exposure. However, should this arrangement be permitted it would likely negate the value of market making for those small retailers who face contracting hurdles because they are riskier counterparties.

Growing a small retail business involves specific challenges

Third, it remains unclear whether it would allow small counterparties to enter the market because trade sizes are unlikely to be small enough to cover the issues faced by small retailers. This is because whether 1 megawatt or 5 megawatts, traded markets provide relatively blunt risk management instruments for new entrants without scale. As noted earlier, it is also why the United Kingdom scheme was not in ENGIE's view targeted at small purchasers with alternative policies developed for that purpose.

Physical players have natural limits they cannot exceed without consequences

Fourth, the market making obligation will not increase hedges available beyond the underlying generator's ability to meet its financial obligations. Generators, whether vertically integrated or not, are not typically speculators. As a generator's contract book approaches the spot period, its available contracting headroom will tend to shrink to or below its expected financial value of generation over the relevant period. As identified, changing contracting patterns reduces the efficiencies provided by vertical integration.

Notably in South Australia, a gas fired generator's 'natural limit' to provide risk management products is impacted by gas market liquidity and thus gas fired generators tend to be conservative to account for this. Market making obligations in the electricity market on their own will likely not increase the level of liquidity and may in fact reduce the level of liquidity in electricity contracts in response to the participants reduced ability to manage risk.

Additionally, the obligation may reduce the obligated party's risk tolerance. This is because higher levels of risk taking may provide a portfolio benefit, where the integrated retailer and generator are on different sides of the risk. Where the risk or benefit is externalised and does not provide a portfolio benefit, a generator may be reluctant to take on the same level of risk, given the possibility of a loss to it without a commensurate gain.

Operating constraints may negate the value of market making

The ESB Consultation Paper quite rightly notes that generator outages and fuel availability (gas liquidity is a material and key issue in South Australia) needs to be considered in the context of market making obligations placed upon physical participants. This is because market making cannot result in generators offering contracts where their generation availability is affected by factors such as conditions in fuel markets, physical constraints and prices in hedge markets. ENGIE suggests that the AEMC explore these issues more fully as they are likely to have a more material impact on electricity contract liquidity than vertical integration.

Economic and physical fuel constraints (adverse weather, drought, interruptions to coal supplies, inability to source gas permanently/at short notice/in sufficient quantities and granularity) and uneconomic input fuel costs (high gas prices) are all reasons why a generator, whether vertically integrated or not, cannot sensibly provide hedge contracts up to the full extent of its risked capacity.

Once all these factors are taken into consideration, for most, if not all, generators, the outcomes should reflect the hedge offerings which are in accordance with the existing business plans of those physical generators.

It is not appropriate for obligated parties to take on unnecessary costs

Sixth, market making should not force obligated parties to trade at a loss.

The analysis by Ofgem[v] of the United Kingdom's scheme provided evidence that the costs of the scheme, measured by the inability of obligated market makers to move their prices sufficiently and rapidly during periods of high volatility, resulted in costs significantly higher than was anticipated.

Additional and significant IT costs were also faced by obligated parties who implemented detailed algorithms to determine the appropriate prices in given trading periods.

If obligated parties faced losses this will impact future capacity availability and investment.

<u>Are mandatory obligations on physical participants the only option?</u>

In addition to the issues above, it would appear the current Australian Financial Service License arrangements prohibit participants in a market acting as market makers unless they are licensed to do so (and arguably for good reason). With that in mind, it seems worth investigating what parties may be comfortable performing a market making role more commercially.

Forced participation of physical players seems contrary to appropriate risk allocation which is an underpinning driver of the NEM design and ignores the important role that financial intermediaries play in the market for derivatives. Likewise, the existing financial markets could be used to encourage parties to take up market making obligations for a fee, as is the case in Singapore which deserves closer attention, where the ENGIE Group also has trading operations and has a long involvement in market development in that region.

Interestingly, and as raised by other participants, the ASX is currently testing interest in market making as part of its ASX Market Making Incentive Scheme. Complementing that arrangement to develop a requirement based on voluntary participation is an important consideration. A compulsory impost may undermine the business case for those participants who were willingly able to provide such a service.

4. Summary of proposed changes

This proposal to introduce a market making arrangement is based on the following conditions which would require changes to the NER to give it effect.

Arrangement to make a market

- The NER mandate the conduct of a tender for market making responsibilities in the NEM.
- The tender be conducted by the Australian Energy Regulator (AER).
- The tender be conducted every three to five years.

The market making obligation conditions

- The tender to cover all regions.
- The tender and market making obligation to be independent of the NEG reliability obligation, and therefore any market making obligations previously proposed by the NEG should be considered unwarranted.
- The market making obligation remains in place on an ongoing basis with no triggering mechanism.
- The successful tenderer would be required to offer bank guarantees or assurances in the event of their financial failure.
- Penalties for non-performance to be a feature of the arrangement.

Tender terms and cost recovery

- The tender documentation will outline the parcel size, required cumulative exposure, required spreads, and period of offer for each region that will remain in place during the three to five year period.
- The tender be open to financial or other providers who have the technical capacity to arrange for market making across relevant regions of the NEM (i.e. banks, ASX, brokers)
- The successful tender be permitted to sub-contract directly with any number of physical and financial market participants to provide the required services in each region that it has an associated obligation pursuant to the tender outcomes.
- The successful tenderer be required to manage the risk of default of market making positions of those participants it engages.
- The successful tenderer be permitted to arrange such arrangements by contract on such terms and conditions as the two parties willingly agree.
- The costs of engaging the tenderer to be recovered from customers.

Governance and monitoring

- The AEMC to review the operation of the arrangements in advance of each tender and form a view.
- All conditions of the tender are set by the AER and publicised in advance of the tender.
- Market monitoring depends on the type of product.

Each of these matters is enunciated below and will require further consideration and consultation by the AEMC.

5. Arrangement to make a market

<u>The NER mandate the conduct of a tender for market making responsibilities in the NEM.</u>

The proposal differs from the ACCC Retail Report and ESB Consultation Paper in that it proposes a tender be conducted where parties can voluntarily nominate to perform market making. ENGIE favours this approach based on four key conclusions.

First, as operator of the Pelican Point Power Station ENGIE is actively in the market seeking to provide hedges to willing counterparties. Where smaller market participants have indicated to the ACCC that they are unable to contract this is highly unlikely to be because they have not been offered a price and contract terms.

Where terms may be unfavourable, for either party, it is not appropriate for one party to be forced to accept terms and conditions which are unfavourable to subsidise the other party. In fact, requiring a party to take on additional risk or offer hedges below cost will only serve to undermine asset viability and work to further destabilise the South Australian market.

Thus, any conclusion that forced market making in South Australia would be in the long-term interests of consumers and meet the NEO, has failed to examine the impacts on disadvantaged parties and failed to appreciate the long-term effects. This would include increased risk of loss given default and a disincentive for investors, and potential early retirements.

A tender where parties who are willing to take on additional risk for a price would not create these additional risks for existing market participants and would provide a new service in the market.

Second, the scheme adopted by the Singapore Energy Market Authority provides a useful reference case, where six market makers are providing liquidity support services to the electricity futures market. The design of the scheme, which employs a tender, avoided the need for mandatory participation by physical players, thereby enabling the companies that were best placed to provide the service to do so on a commercial basis.

Third, the willingness of financial intermediaries to enter the market more generally in Australia demonstrates that sophisticated intermediaries are effective at managing and pricing financial risk. There is no reason to believe that such participants, and non-market parties, would be unable to offer a market making service.

Such an approach would obviate the need to expose physical players to risk they are unwilling to hold of their own volition. In short, vertical integration should not be broadly used as a justification for imposing questionable conditions on physical participants.

Fourth, the collapse of the United Kingdom scheme, which has compulsory obligations, is indicative of the issues that may arise in the NEM.

As well as the issues covered in the section 2 of this paper, the challenges in the United Kingdom included restructuring and asset transfers changing the number of participants who would be required to provide the service. In such an environment, the ability of the remaining participants to manage the obligation is being openly questioned.

Proposition: A tender is the most appropriate method for identifying parties who have the sophistication and appetite to take on additional risk that cannot be readily managed by physical participants at this time.

The tender be conducted by the Australian Energy Regulator

The Australian Energy Regulator is suggested as the most appropriate entity to conduct the tender while noting other possibilities exist. This includes relevant state governments or the Australian Energy Market Operator. In some respects, the mechanism for funding may impact the decision.

Nevertheless, ENGIE's initial assessment supports the AER performing the role for reasons of stability and capability.

Proposition: The tender be conducted by the Australian Energy Regulator.

6. The market making obligation conditions

<u>The tender be conducted every three to five years</u>

The ACCC Retail Report talks of a two-year trial. Leaving aside ENGIE's concern that significant new impediments be trialled on physical participants without regard to the risk implications, a period of review is clearly needed to adjust the arrangement and test the market for efficiencies. Nonetheless, given the nature of the arrangement, sufficient time is also needed to recover costs and for participants not to be captured by one or two seasons of risk (i.e. a drought year only).

ENGIE suggests somewhere between three and five years would be an appropriate period.

Proposition: Between three and five years is an appropriate period for the market making arrangement to apply with a tender to be conducted at the end of each period to test the market.

<u>The tender and market making obligation to be independent of the NEG reliability obligation, and therefore any market making obligations previously proposed by the NEG should be considered unwarranted</u>

Given the arrangement that is proposed there is no reason to tie the market making obligation to the NEG and vice versa. This element of the NEG now becomes redundant.

Proposition: An ongoing market making obligation eliminates the need for market making to be considered as part of the NEG.

<u>The tender to cover all regions</u>

ENGIE notes that should the obligation only apply to one region, as others have suggested, this will further limit risk allocation.

South Australian participants can and do access a variety of products to manage risk, this includes South Australian hedges, but also weather derivatives, insurances, demand response, and hedges from other regions. The use of Victorian hedges with or without Settlement Residue Auction are used by South Australia participants.

In ENGIE's view, mandating market making in one region should automatically lead to it being adopted in other regions to support risk management. The worst possible outcome under the ACCC Retail Report proposal would be a South Australian physical participant unable to offload risk it was not capable of holding.

Under this proposal, given there are no specific triggers for implementing market making, it will mean that market making is in place in all regions at all times. Naturally, risk will only be present where, or if, market making is actually needed in a specific region due to market conditions. Market making in most regions would remain low cost most of the time, and would unlikely to be relied upon where contract availability was already sufficient, but the arrangement would provide a fail-safe mechanism should conditions change in any given region at a point in time.

Additionally, ongoing operation alleviates the need for government agencies to develop triggers that are somewhat arbitrary and assess those triggers for possible action on an ongoing basis. Such discretion creates unnecessary uncertainty in the market.

Where a party nominates to tender that party will need to take a view of liquidity challenges over the tender period and take steps to ensure hedge availability. Where there is unlikely to be a strong appetite or any gap in the market, the tenderer should nominate a low or small fee to provide the service but accept the risk that market conditions will change based on probability of exceedance in their models. This is a market led process and should be preferred.

Proposition: All regions should be included all the time to act as a fail-safe for providers in regions where hedging risk is the most challenging and alleviate the need for arbitrary triggers to be set and measured.

<u>The market making obligation remains in place on an ongoing basis with no triggering mechanism</u>

Each of the triggering mechanisms discussed in the ESB Consultation Paper has limited appeal and would create concerns for entities that may be captured. This lack of certainty seems contrary to the spirit of the NEG, which was promoted for a number of sensible reasons including increased policy certainty.

To maximise certainty for market participants, an all regions at all times obligation is proposed.

The benefit of such an arrangement is that the main variable for the successful tenderer is whether they forecast market volatility correctly not whether a central department or other agency decides one way or another. The successful tenderer is therefore 100% in control of its own expectations and risk appetite based on their own market intelligence. This should be no different from a financial intermediary who enters the market to trade hedges and manages it financial exposure based on its risk appetite.

Proposition: A voluntary participant who seeks to provide a market making service in the NEM is best placed to determine their risk appetite based on market expectations over the tender period.

<u>The successful tenderer would be required to offer bank guarantees or assurances in the event of their financial failure</u>

The most notable risk in a market making arrangement is that the party making a market fails financially and leaves counterparties exposed.

In the model proposed in the ACCC Retail Report and canvassed by the ESB Consultation Paper, ENGIE's concern would be that the obligated physical participant would be exposed to unmeasurable market risks. In such a circumstance the outcome would be difficult to manage and hard to estimate in advance. This is not the primary concern in this proposal.

As the successful party has sought to take on this risk, the bigger concern is that the party underestimates the risk and leaves its counterparties exposed. To manage this risk, the successful tenderer would need to lodge appropriate bank guarantees or financial assurances. These prudential arrangements should be modelled on the current arrangements applied to parties trading in the NEM.

Proposition: Prudential obligations consistent with those that apply in the NEM to existing participants should be suitable for successful tenders.

Penalties for non-performance to be a feature of the arrangement

ENGIE notes that in the Singapore scheme there are quite severe penalties for non-performance. There seems to be a strong case where a tender is used, and a market maker is likely to receive a benefit from performing the role, it should also be exposed to punishment where it does not meet the obligations agreed through the tender.

Proposition: A successful tender who fails to fulfil their market making obligations should be exposed to appropriate penalties.

7. Tender terms and cost recovery

The tender documentation will outline the parcel size, required cumulative exposure, required spreads, and period of offer for each region that will remain in place during the three to five year period

To best enable a tenderer to calculate the risk inherent in winning the obligation to make a market, the tender should clearly state in advance the following terms.

- The tender duration, suggested as between three and five years.
- The parcel size and times at which those parcels would be offered.
- The offer spread that is to be made available.
- Whether the price is pegged to the market variables or unpegged.
- Whether credit support can be requested from riskier counterparties.
- The cumulative position that a participant would be expected to hold at any one time.

For example, in an environment where all but one or two regions were operating in a manner which negated the attractiveness of purchasing from a market maker, whether an offer is available at all times or only at specified times becomes largely irrelevant.

Hence, a tenderer is most likely to be concerned by the total risk that they would be required to take on. Would there be a cap on that risk or not? A cap obligation will be easier to manage and therefore price than an uncapped obligation that merely requires a daily offer against a set spread regardless of whether anyone takes that offer up or not. Likewise, allowing parties to seek additional credit support from riskier parties will make an obligation easier to manage and reduce the tender price.

Each of these conditions involves a trade-off. Many of these items were referenced in the ESB Consultation Paper and therefore input from industry participants and stakeholders should be forthcoming. This is particularly valuable for the first tender iteration with the ability to refine the subsequent tenders based on analysis by relevant parties (see Governance section of this proposal).

The critical point remains that whichever conditions are ultimately proposed, fixing them for the tender term is the only way a participant can price the risk.

Proposition: Market making conditions need to be set in advance of each tender and not varied during the obligation period.

The tender be open to financial or other providers who have the technical capacity to arrange for market making across relevant regions of the NEM (i.e. banks, ASX, brokers)

As discussed, there is no strong rationale for limiting market making to physical participants. Arguably, there is a case that specialists who do not own physical generation may be best placed to tender for the services.

In fact, by limiting the tender to parties who are not physical participants, it may minimise perverse incentives for physical participants to withhold generation. Neither the ACCC Retail Report or the ESB Consultation Paper considered the likelihood that physical participants would have incentives to withhold created by placing mandatory market making obligations on them. But it is undoubtedly the case.

Similarly, if a tender is limited to physical participants, similar incentives may arise in the short term. But those same participants will not be affected, or in a very limited way, if their primary role sub-contracting to a successful tenderer or selling their risk instruments in the market in the same manner as is already the case, voluntarily.

ENGIE appreciates that the operation of the tender, and who is or is not permitted to tender, is likely to raise any number of philosophical questions about the design of the NEM if not adequately addressed. As such, there is significant benefit in ensuring parties only be required to offer risk instruments they would be willing to do so voluntarily (under appropriate market conditions). The tender can operate consistent with this approach.

Proposition: Financial providers will be well placed to fulfil the role of market maker.

The successful tender be permitted to sub-contract directly with any number of physical and financial market participants to provide the required services in each region that it has an associated obligation pursuant to the tender outcomes

As indicated above, a successful tenderer will look for ways to offload risk. This may include sub-contracting physical generators or others to provide specific services. This is a very efficient way for the market maker to act.

For instance, it may be the case that engaging in a contract with a single generator to run over an extended period when they otherwise would have not done so may ultimately minimise the risk for the market maker as prices will be suppressed. In this regard, the market maker is acting in a fashion that each small player (or an aggregation of small players) would do so if they had the capacity to contract.

By having the successful tenderer perform this function they can sculp contracts and hedges with other market players in a way which matches their risk profile, which has been determined based on the tender conditions and subsequent bid. This is a more effective and efficient way of parties managing risk than government centrally determining what each parties obligation should be.

Proposition: "Sub-contracting" market making or hedging market making risk with physical participants and other financial intermediaries is an appropriate way to manage market making obligations.

The successful tenderer be required to manage the risk of default of market making positions of those participants it engages

As indicated above, a successful tenderer needs to manage the risk of its own default through appropriate financial assurances. Conversely, the market maker will be exposed to the risk of sub-contracted market making entities defaulting. That risk should be priced into the parties successful tender and its sub-contracts and hedges.

Proposition: The successful tenderer will need to account for potential default of sub-contracted parties with no additional mechanisms to be implemented to alleviate the costs of such defaults.

The successful tenderer be permitted to arrange such arrangements by contract on such terms and conditions as the two parties willingly agree

There is no need for government or other agencies to interfere in arrangements with parties who freely contract with the successful tender. Thus, whether the contract between the market maker and a sub-contracted party is based on physical or financial, and based on weather, market prices, conditions or otherwise, those parties should be free to contract in their best interests.

Proposition: The existing financial markets and contracting practices for the NEM can be used by the successful tenderer to offload risk within each region.

The costs of engaging the tenderer to be recovered from customers

Market making is a service that has been proposed in the interest of customers. On that basis, a cost recovery mechanism should be implemented across the NEM to recover the successful tenderer's fee from customers. This is the position that was arrived at in Singapore following an extensive debate.

Proposition: The successful tenderer's fee should be recovered from customers across the NEM.

8. Governance and monitoring

The AEMC to review the operation of the arrangements in advance of each tender and form a view

Should it proceed, the initial tender will have conditions set based on the best judgement of the AER and the AEMC's rule determination; however, the value and impact on the market is critical to determining the conditions for subsequent tenders and this is where an annual assessment of market making should be conducted. The performance of the tenderer will also need to be assessed by the AER but the AEMC seems best placed to comment on the long-term implication for the market of specific sets of conditions and continuation of the arrangement in one form or another.

Proposition: The AEMC should conduct an assessment of market making arrangements in the NEM prior to subsequent tenders by the AER.

All conditions of the tender are set by the AER and publicised in advance of the tender

The AER will need to issue written guidance prior to the tender period following input from the AEMC and feedback from market participants and stakeholders as appropriate.

Proposition: The AER is the body that should issue final guidance on the conduct of the tender and the final tender terms.

Performance monitoring depends on the type of product and participant

Depending on the products offered to satisfy market making the form of monitoring may differ. If products are provided entirely on the ASX, for example 'vanilla' swaps, there will be little need for formal monitoring by the AER and it may more appropriately be the domain of the Australian Securities and Investments Commission. This will also have the commensurate benefit of managing financial default and counterparty risk more clearly.

Alternatively, if OTC products are used, there may be the case for more direct reporting to the AER to ensure the market maker is performing the obligations outlined in the tender.

ENGIE believes a number of different products could be used to satisfy market making and that the tender process should be capable of allowing tenderers flexibility to ensure efficiency is maximised. This ultimately will have implications for performance monitoring.

Proposition: The form of monitoring, and appropriate body, will be dependent on manner in which the market makers obligation is discharged and could require multiple agencies.

9. National Electricity Objective

As with all proposed changes to the NER, this proposal must meet the NEO. The NEO is stated in section 7 of the National Electricity Law as:

> . . . to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
>
> a. price, quality, safety, reliability and security of supply of electricity; and
>
> b. the reliability, safety and security of the national electricity system.

ENGIE has reached the conclusion that the proposal is in the long-term interests of customers as it will promote a number of beneficial outcomes consistent with the NEO as outlined below.

- An economically efficient allocation of risk occurs between parties in the NEM including management of new entrant retailers without placing unmanageable risk on selected physical participants.
- Commercial drivers underpinning individual market participants hedge positions and trade in risk management instruments are not distorted.
- Services that are provided outside the normal course of market conditions are provided in a transparent manner with appropriate cost recovery.
- Shareholders and investors' expectations are not undermined by potential compulsory market making obligations so as to avoid placing a further risk premium on investment in specific or all regions of the NEM to account for unmanageable risk and unrecoverable costs.
- Encourage entrance of specialist providers who may be better placed to support market making services.

- Minimises need for interventions which will directly impact existing businesses based on centralised decision-making.
- Minimise the potential for entities to provide financial risk management services beyond their capability to do so (e.g. obligations to provide hedges that exceed the financial capability of the underlying generation asset).

Notably, ENGIE believes the compulsory market making arrangements that have been discussed recently by the ACCC and ESB would likely fail to meet each of the conditions outlined above. ENGIE has carefully considered the risks and challenges associated with market making and believes this proposal can overcome the deficiencies of alternatives while noting all forms of intervention likely have long term impacts.

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[i] Energy Security Board (2018), Consultation paper: Market making requirements in the NEM, September, p.5
[ii] Ofgem (2017), Secure and Promote Review: Consultation on changes to the special licence condition, p.10
[iii] Competition and Markets Authority (2016), p. 20
[iv] https://www.ofgem.gov.uk/publications-and-updates/open-letter-secure-and-promote-update
[v] [v] Ofgem (2017), Secure and Promote Review: Consultation on changes to the special licence condition, p.10