

12 February 2019

John Pierce AO
Chairman
Australian Energy Market Commission
Sydney South NSW 1235

Submitted online: www.aemc.gov.au

Dear Mr Pierce

MARKET MAKING ARRANGEMENTS IN THE NEM – CONSULTATION PAPER

Origin Energy Limited (Origin) welcomes the opportunity to provide comments on the Australian Energy Market Commission's (AEMC) Market Making Arrangements in the NEM Consultation Paper.

Origin does not support a mandatory approach to market making as this will unduly increase the risk for potential market makers and is therefore unlikely to result in net benefits. We also note that regions throughout the National Electricity Market (NEM) have generally exhibited a sufficient level of liquidity, though lower levels have been observed in South Australia. While voluntary market making can strike the right balance by mitigating risks for the market maker whilst helping to enhance liquidity levels, realistic expectations should be established given the many factors that can impact liquidity. These include the exit of coal fired generation (which could reduce the supply of traditional contracts) and the region-specific issues affecting South Australia. Market making should not be viewed as a universal fix that can address all the underlying issues that could influence future liquidity levels.

Origin does not consider a centralised tender process (and hence the proposed rule change) necessary, given voluntary market making is likely to emerge organically through the ASX process¹. It is also not clear the Australia Energy Regulator (AER) is the most appropriate body to introduce market making in the NEM. The AEMC should also remain mindful that the contracts market is one means by which participants can manage risk and that other tools are available which could gain in prominence as the market evolves.

Liquidity and Risk Management in the NEM

Conceptually, liquidity is where a trade can occur quickly without affecting the asset's price. Notwithstanding this relatively straightforward definition, in contemplating the merits of the proposed rule and the issues discussed in the Consultation Paper, there are several issues the AEMC should bear in mind:

1. *Observations of liquidity levels alone do not provide a complete picture of how market participants currently manage risk in the market.*

Liquid contract markets are important to the extent they enable participants to manage exposure to the NEM's inherent spot price volatility, but there are also other avenues for managing this risk. Some of these include:

- Settlement Residue Auctions (SRA's). With a focus on increasing interconnection between regions in the NEM, there should be greater access to SRA's as a means of managing inter-regional price differentials;

¹ Expressions of Interest in Market Making in the ASX Australian Electricity Futures, Caps & options Market, https://www.asxenergy.com.au/newsroom/industry_news/market-making-expressions-of-, ASX, 30 July 2018

- Weather derivatives – can be used to supplement cap contracts to manage exposure to extreme demand;
- Power purchase agreements (PPA's) (including corporate PPA's). Lower costs have seen a growth in renewable generation with both retailers and C&I customers underwriting PPAs, to help manage their energy position. The growth in corporate PPA's by C&I customers, enables them to offset against their demand and effectively mitigate the risk for retailers;
- Demand response coupled with strategic spot market exposure. In periods of benign spot price volatility, participants may choose to take more exposure as it would be cheaper than the risk premium of buying hedge contracts. Pool exposure combined with demand response can also prove to be viable strategy for some participants, as it would allow them to capture the benefit of both low and high prices; and
- Load following and other 'bespoke' over-the-counter hedges. This may be preferred as it provides better risk cover in the event of load and shape variations.

These products can create 'synthetic generators' enabling participants to protect themselves against spot market risk, much like the contract market has traditionally done.

2. Generally, the NEM regions have exhibited a suitable level of liquidity to support risk management.

The AER found² that Queensland, NSW and Victoria have regular trading in the contract market, a sign of high liquidity. In contrast, South Australia has seen a tightening in the contract market with the retirement of large coal generation in the State. It is also important to remain mindful that South Australia has a higher dependence on non-firm renewables and interconnected energy. This makes it more difficult to underwrite firm financial hedges, increasing the likelihood of lower contract market liquidity in that region compared to others. We consider these factors important in the AEMC determining if there is in fact a problem to be solved through this rule change process, and the extent to which market making is the solution.

Ascertaining the adequacy of liquidity levels in a region is also not necessarily a straightforward exercise, and several factors should be considered in any future assessment of liquidity. Some of the relevant indicators include:

- churn – (the number of times electricity which is generated, is traded compared to physically traded across exchanges and possibly OTC);
- the Volume of trades in the market;
- bid/ ask spread levels;
- number of active counterparties who execute trades (over a sufficient period); and
- the number of transactions (over a sufficient period).

3. Many factors impact liquidity and so realistic expectations of what any market making scheme can achieve should be established.

Market making schemes are intended to focus on one factor that can influence liquidity - the incentive for some participants to engage in the market. In our view, integrated retailers already have a strong incentive to participate in the contracts market to mitigate the spot price exposure (given load and generation are not perfectly match). Notwithstanding this, even if the AEMC was to form a view that market making would promote greater participation in the contracts market and hence higher liquidity levels, there are many other factors impacting liquidity. This means that even a 'successful' market making scheme will have limited means of improving liquidity given these factors, which are discussed below:

² State of the Energy Market Report, Australian Energy Regulatory, 17th December, 2018

- Coal generators reaching the end of their life. There will be a progressive retirement of plants, lowering the supply of contracts available;
- the aging of coal generators could have implications for plant reliability, resulting in a more conservative approach to contracting;
- The lower costs of renewables will see an increasing proportion of intermittent generation entering the market. Given their nature these generation sources are unable to firm contracts and will lead to less traditional contracts available. However, cheaper prices for renewables has seen an emergence of PPA's for participants to utilise for risk management. To compliment this, storage and demand response are other avenues the market may turn to for risk mitigation; and
- Prudential requirements when trading on the futures exchange or via OTC's, can prove challenging for smaller participants and as such, they may utilise other risk management tools.

4. *Mandatory market making will result in inefficient outcomes, and should not be pursued.*

The AEMC, has identified several market making options. Origin does not support mandatory market making and it should not be pursued given that it has the potential to distort the market and lead to unintended consequences. Market making obligations instituted by Ofgem in the United Kingdom (UK) resulted in the drawing of activity away from other parts of the day, into the market making windows. This reduction in liquidity outside of the market making period (which limits trading opportunities) may become a disincentive for new participants to enter the market and could be a cause for concern around the market's ability to operate efficiently.

Additionally, the UK also saw an increase in compliance costs on obligated participants due to prescribed bid/offer spreads during periods of volatility, which made it difficult for the market maker to manage their own position. This was most pronounced at the start of the market making window.

If the AEMC concludes that market making should be a feature of the NEM, the optimal approach would be a voluntary scheme, as this allows the market to efficiently provide the services by balancing enhanced contracting opportunities against the associated risk. We do not, however, consider a rule change necessary given that voluntary market making is likely to emerge organically through the ASX process and so a centralised tender process is not required. It is also not clear that the AER is the most appropriate body to introduce market making in the NEM. Additionally, while the compensation framework set out in the rule change could incentivise greater participation in any market making scheme, we are wary of additional costs being passed on to consumers.

If as expected a future market making scheme is subject to review and monitoring, the broader issues around risk management raised earlier in this submission should be considered. Additionally, policy makers should remain cognisant of the inherent limitations of market making to promote liquidity given the influence of other key variables.

Market Making Design options

A well-designed market making scheme will minimise market distortion. We discuss our views on some of the relevant parameters in the attached Appendix.

If you wish to discuss any aspect of this submission further, please contact Kian Mohammadih at Kian.Mohammadih@originenergy.com.au or on 02 9503 5970.

Yours Sincerely,



Steve Reid
Group Manager, Regulatory Policy

APPENDIX 1

Table 1 – Market making design features

Market feature	Optimal level	Reasoning
Volume	1MW-5MW	<ul style="list-style-type: none"> - 5MW is ideal, but SA due its market size could require smaller volumes. - Any volume larger than 5 MW may make it more difficult for market makers to cover their position or trade-out, especially if multiple market making bids and offers are to be made in a window.
Bid/ Offer Spread	5%-10%	<ul style="list-style-type: none"> - UK and NZ both have 5%. - An inflexible limit for market makers has costs and risks, as has been seen in the UK. Upon review by Ofgem, it was found that obligated participants wore unfair risk and extra costs in the opening of market making windows, especially in periods of high volatility, due to information asymmetry. - With information asymmetry, market makers without sufficient spread and having uncertainty around price, are forced to wear more risk, unfairly benefiting speculators. Consideration should be given to having a higher spread (e.g. 10%) when prices are highly volatile, ensuring market makers aren't disadvantaged by having to make markets in less certain times.
Products	Baseload Quarterly Futures (Cal/ FY strips)	<ul style="list-style-type: none"> - Baseload futures are the most commonly traded product. Cap prices are historically more volatile, than baseload futures, which would increase the risk for the market maker. Given this, our preference would be for caps to not be included in any initial market making scheme or for additional protections to be put in place e.g. in the form of a wider spread. - Due to their bespoke nature non-exchange traded products (such as OTC's) should not be included. The non-standard nature of these products means they are more suited to bilateral contracting arrangements.

Market Making window	Half hour between 10:30-11:30am	<ul style="list-style-type: none"> - The market making window should operate in the late morning (around 11am) - In the UK, the creation of market making resulted in most trading moving to the market making window and other periods becoming less liquid. If such behaviour was replicated in the NEM, then having a window at the end of the day would drive most trades to the last half hour. Pushing a potential 6 hours of daily trading opportunity to the last half hour, would in the longer term, be a negative outcome on the efficiency of the market. - Market makers take on more risk. Setting the window early, allows these participants the ability to hedge out and account for positions that same day, increasing the chances of spreading out trading throughout the day.
Limits	Consideration should be given to limiting the total volume offered by a market maker in a specified period (e.g. over a month).	<ul style="list-style-type: none"> - Since market makers would have to find sufficient generation capacity to back their trades, having no limits or a volume limit that is too high would make it difficult for them to match their portfolio, increasing risk. The market maker may either have to: <ul style="list-style-type: none"> o buy this volume back from other market makers— nullifying the benefit to small retailers as it may trigger a cycle of higher prices; or o be forced into a short position, taking undue spot market risk. Forcing more spot price risk onto the largest generators in the NEM could bring in systemic risk. - Daily limits could also be considered, as a monthly volume limit may be taken early in the month by a few large volume trades, thus resulting in no market making activity for the remainder of the period. - Consideration should be given to how insufficient limits may also force market makers to breach their own internal risk limits.
Market Sensitive Information	Exempt from market making	<ul style="list-style-type: none"> - Anything that affects a market maker's ability to make prices, for e.g; <ul style="list-style-type: none"> o trading Halts, o possession or release of market sensitive information, o unplanned unit outage information, o anything else of a significant nature, <p>should remove the obligation on them to make a market for the period the information is in effect (as per normal market operation).</p>
Region	SA focus	<ul style="list-style-type: none"> - SA to be primary focus due to historically low levels of contract market liquidity. However, a voluntary scheme could apply to all regions
Penalties	No compensation	<ul style="list-style-type: none"> - Market makers that fail to provide the services should not receive compensation for the month in which they failed to provide (subject to allowed reasons and allowed monthly limits for not providing)

Market Makers	Physical and third party participants to be able to provide services	- Subject to mechanisms that ensure the market is not adversely effected in the event of default by a third party participant.
Sub-contracting	Yes	- May enable more competition and participants.