

10 July 2025

Australian Energy Market Commission

Submitted online



IRSR arrangements – Directions Paper

The Australian Financial Markets Association (AFMA) is responding to the AEMC's Directions Paper for the IRSR Arrangements for Transmission Loops rule change.

AFMA is the leading financial markets industry association promoting efficiency, integrity and professionalism in Australia's financial markets, including the capital, credit, derivatives, foreign exchange, energy, environmental, carbon, and other specialist markets. Our membership base is comprised of over 130 of Australia's leading financial market participants, including many energy firms who are key participants in the NEM and the settlement residue auction.

Key Points

- **The AEMC has got this rule change wrong**
 - **The AEMC's proposed option will increase prices for consumers**
 - **Poor management of the rule change process has left inadequate time to consider the issues identified during the process**
-

AFMA's members have fundamental concerns with the AEMC's proposed approach to netting positive and negative settlement residues. We consider that the AEMC has not understood the role of the Settlement Residue Auction (SRA) and that the proposed rule will have a negative impact on consumers. We consider that the proposed changes will not result in the savings the AEMC anticipates but will increase the cost of hedging which will flow through to higher consumer prices.

Additionally, we consider that the AEMC's handling of the rule change process has been disappointing, leading to delays and inadequate time to consider the key issues identified during the rule change process. Energy Networks Australia raised valid concerns about the challenges of forecasting negative residues and the impact that this has on Transmission Network Service Providers (TNSPs) cashflows in response to the initial consultation paper. The AEMC did not engage with these issues in the Draft Determination and, by changing the way costs are allocated, appears to have accidentally exacerbated them for NSW. The AEMC then radically changed track in this direction paper while only superficially considering other options to address the TNSPs concerns and leaving inadequate time to address TNSP and market participant concerns.

1. Areas requiring further consideration

1.1. Role of the Settlement Residue Auction

AFMA considers that the AEMC has not understood the role that SRA units play in the market. The discussion in your initial consultation paper, which is largely repeated in the directions paper, gives the impression that the AEMC considers that the only role of the SRA is to transfer wealth from consumers to market participants. A better understanding is required of the role the auction plays in converting the settlement residues, that are a natural product of a regional market, into an

instrument that can support inter-regional trading for the benefit of consumers. It is also important to remember that the value of SRA units to support inter-regional trade is a key component of the business case to support interconnector developments like Project Energy Connect and that the value of these projects to the market would be diminished as the value of Settlement Residue Auction Units was reduced.

Some of the key components of the SRA requiring common understanding are:

- **Positive Residues** – the directions paper presents the allocation of positive residues through SRA units as a windfall gain for market participants at the cost of consumers. We want to reiterate our previous comments that both positive and negative settlement residues are a natural consequence of a regional market and that market customers use the revenue from SRA units to offset the costs they incur managing inter-regional price separation. For example, a retailer with generation in a low priced region and customers in an adjoining high priced region can use the proceeds from SRA units to offset the loss they make in the spot market, as a result of being paid less for their generation output than they have to pay for their customer load. This allows them to offer lower priced products to consumers in the importing region.
- **Negative Residues** – the paper presents negative residues as a cost that has been unfairly shifted to consumers. We want to point out that negative residues, like positive residues, are an inevitable feature of regional market and that the cost has to be recovered somehow. We discuss the cost to consumers below.
- **Volatility of SRA units** – the paper presents netting of negative and positive residues as a benefit for market customers as it will reduce the volatility of SRA units value which the AEMC considers will reduce the risk faced by market customers. We think this analysis does not take account of how SRA units are used.

As we said in our response to the draft determination,¹ SRA units are used to hedge inter-regional price risk not inter-regional settlement residues. As a result, the key element that makes them a valuable hedge is their correlation to the value of the energy flowing between the two regions. Netting reduces this correlation, which would make their value less volatile, but would also undermine their value as a risk management tool as the match between the volatility of SRA units and inter-regional price risk is what gives SRA units their value and makes them an effective risk management tool. As a result, reducing the volatility of SRA units will reduce their usefulness.

AFMA wants to emphasise that negative residues occur when physical issues in the system cause power to flow from a high-priced region to a lower-priced region. They do not represent the clear transfer of value from consumers to market participants described in the directions paper. The impact on consumers is complicated as under the current arrangements consumers in the importing region benefit from lower spot prices while consumers in the exporting region pay higher prices for generation used in the importing region.

Currently, the cost of negative residues is allocated to customers in the importing region, which makes sense as they have benefitted from lower spot market prices. Under the proposed rule, the costs are allocated to SRA unit holders, who are likely to be generators in the exporting region. This effectively means the exporting region consumers will pay higher spot prices and exporting region generators will pay through lower SRA payments, while consumers in the importing region do not bear any of the cost. It is not clear to AFMA that this is a fairer allocation than under the current arrangements.

¹ <https://www.aemc.gov.au/sites/default/files/2025-01/R06-25%20PEC%20draft%20determination.pdf>

1.2. Consumer Impact

The stated rationale for the AEMC issuing the directions paper is that it better manages costs for consumers than the alternative approach adopted by the AEMC in the draft determination. We disagree with the AEMC's assessment and consider that the proposed changes will increase costs for consumers compared to the approach adopted in the draft determination or AEMO's original proposal.

- **Netting does not reduce consumer costs** – one of the pieces of reasoning that we find most puzzling in the directions paper is the AEMC's view that netting of negative residues will decrease their cost to consumers. Currently, the cost of negative residues is recovered transparently through Transmission Use of System (TUOS) charges. Under the proposed approach the cost to consumers will not be reduced but will become less transparent. We anticipate that the impact of the change will be:
 - a) Decreased TNSP revenue from the SRA, that would have otherwise reduced transmission prices, leading to higher TUOS costs for consumers
 - b) Increased hedging costs for retailers leading to higher costs for consumers

The proposed changes will make the cost of negative residues less transparent but will not decrease their costs to consumers.

- **Increased hedging costs** – The main point AFMA has made throughout this consultation is that SRA units are the key mechanism to facilitate inter-regional hedging and that reducing their effectiveness will increase hedging costs which will flow through to higher costs for consumers.

The directions paper recognises that the proposed changes will reduce the value of SRA units as hedging instruments but considers that this is reasonable as market participants "have multiple tools at their disposal to manage inter-regional price risk" and that they will be able to purchase "different or additional hedging products." We agree that participants will have to take alternative measures to manage these risks, but the AEMC has failed to note that these measures will be less efficient than SRA units and therefore more expensive, resulting in higher costs for consumers.

It is worth pointing out that hedging costs typically make up ~35% of end customer bills and as a result even small changes to them can have significant impacts on consumer bills and that the proposed changes will increase these costs.²

- **Decreased competition** – the proposed changes will limit the ability of participants with assets in one region to offer products to neighbouring regions. We anticipate this will reduce retail competition as generators will be less willing to sell hedges for adjoining regions and gentailers will be less willing to offer retail products in regions adjacent to their generation assets. This is likely to result in less choice and higher costs for consumers.
- **Appendix A** – while we appreciate that the worked example in Appendix A is intended to be stylised and illustrative, it does not represent realistic market practice, and we think this makes it unhelpful for the discussion. We have responded to the example at length as we think it illustrates our concerns about the proposed rule. Our key concerns are:
 - a) Gentailer B's position is unrealistic – we consider that B's position is unrealistic under both scenarios. In both scenarios B is presented as attempting to hedge retail loads in both NSW and Victoria with an SA asset. While this is unlikely in practice the point that we think makes it problematic for the scenario is that B only hedges its SA/ Vic exposure. In the first scenario this leaves B long to Victorian prices and

² [AER 2025-6 DMO Final Determination](#)

unhedged to NSW prices for 60% of their total load, while we don't think this is a prudent approach it doesn't really cause any harm to the illustrative value of the first scenario, but we think it is more problematic for the second scenario.

In the second scenario Gentailer A is left underhedged to the NSW spot price as a result of the AEMC's proposed netting approach. The example asserts that this is not problematic because A could enter into some unknown type of trade with B to manage the risk (see discussion of the nature of this trade below).

We think the example is unrealistic, and highly problematic for the AEMC's proposed approach, as it relies on B wanting to increase its exposure to the NSW spot price by selling A a hedge. Given B already has an unhedged NSW exposure for its own load we think it is extremely unlikely that it would have an interest in increasing its unhedged exposure to the NSW spot price by selling A a hedge.

- b) Subsequent trade unlikely – example 2 posits that A and B can “enter into a subsequent trade for the excess \$20/hour” we do not consider this would work as the example expects. The example does not explain the nature of this trade but describes it as “subsequent.” If the AEMC's expectation is that the trade would occur after the relevant NEM trading intervals we think that this is highly unrealistic.

Hedging instruments work because they allow parties to manage future uncertainty. If the trade is done after the trading interval there is no uncertainty to hedge as both A and B know exactly what their cashflows will be. B knows that it has made a profit and A knows it has made a loss. As there is no longer any uncertainty there is no risk to hedge and the only thing that can be traded is the cashflow and at this point, there is no motivation for B to share any of its profits with A, i.e. why would B give A \$20 for anything less than \$20?

- c) Alternative hedging instrument? – While we think it is unlikely that A and B would have an incentive to enter into a trade subsequent to the trading interval, we think it is also unlikely that they would have incentive to enter into a trade prior to the trading interval. As discussed above, B has an unhedged exposure to the NSW spot price and is therefore unlikely to enter into any type of arrangement, such as a NSW swap, that increases this exposure. The one transaction that could occur would be for B to sell down their SA/Vic SRA position but A has no real incentive to buy this as they have no exposure to the Victorian spot price, so it is not a useful instrument for them.

- d) Profits are ok – in your discussion of scenario 1 you indicate that it is undesirable for B to over recover. We strongly disagree that a participant making a profit is a problem as the NEM is a market and participants are supposed to be incentivised to maximise profits, but we also object to the reasoning in this particular example.

As discussed above, B has, in our opinion, entered into a sub-optimal hedging strategy where they are long to the Victorian price and short to the NSW price. While B makes a profit from their position in the first scenario they would be exposed to losses if NSW prices were to be substantial higher than Victorian and SA prices.

While to a degree we think this is a result of poor design of the example, if a party was to adopt this risky position they would be relying on making a profit on their long SA/Vic position, at least some of the time, to offset the risk of losses from their short NSW position.

A more realistic version of the example:

AFMA has attempted to put together a more realistic version of the example to illustrate the challenges of the AEMC's approach.

Gentailers A and B both participate in the SRA to hedge their load in NSW:

- A holds 60% of the SA/NSW SRA units
- B holds 40% of the SA/NSW SRA units

Both gentailers appreciate that they are under hedged in NSW and buy additional NSW swap cover.

B also holds 40% of the SA/Vic SRA units to hedge its Victorian load.

Note: given their limited access to the higher prices in the adjoining regions we anticipate that A and B may choose to back down their generators in SA to reduce running costs, but we do not consider this has any impact on the scenario.

The netted and un-netted SDR unit payouts would be:

Gentailer	Unnetted SA/NSW (per hour)	Unnetted SA/Vic (per hour)	Total unnetted (per hour)	Netted SA/NSW (per hour)	Netted SA/Vic (per hour)	Total netted (per hour)
A	\$60	\$0	\$60	\$48	\$0	\$48
B	\$40	\$80	\$120	\$32	\$64	\$96

Under the non-netted approach SRA units would be equivalent to 10 MW of hedge cover in NSW for A and B and 4 MW in Victoria for B. This would be inadequate hedge cover in NSW for both A and B and they would have bought the following amounts of additional cover to protect against this event:

- A - 4 MW of NSW swap
- B - 2 MW of NSW swap

B would not be required to buy any additional cover for Victoria as the SRA units would offset their position.

Under the netted approach SRA units would be equivalent to 8 MW of hedge cover in NSW and 3.2 MW in Victoria. This would be inadequate hedge cover in both regions, and they would have bought the following amounts of cover to protect against this event:

- A – 5.2 MW of NSW swap (an increase of 1.2 MW)
- B – 3.6 MW of NSW swap and 0.8 MW of Victorian swap (increases of 1.6 MW in NSW and 0.8 MW in Victoria)

Under the netted approach A and B would collectively have to buy 3.6 MW of additional swap cover than under the non-netted approach, despite both scenarios having the same physical energy flows. Assuming a swap price of \$70 MWh (and that you could buy fractions of a MW) collectively A and B would have to pay an additional \$252 for hedge cover under the netted approach, which would be reflected in consumer bills. Assuming customers receive the AEMC's anticipated "reduction" in negative settlement residue cost of \$60 as a result of netting consumers would end up net \$192 worse off than under the netted approach.

Observations:

- SRA units are a more effective hedge under the non-netted approach, allowing them to be used more effectively as an alternative to other types of financial product.
- Participants are likely to need to buy more non-SRA hedge cover under the netted approach, which would be expected to increase the cost of swaps and caps.
- The value of SRA units would be likely to decline under the netted approach.
- It is likely that additional generation would have to be built in each region to compensate for the decreased value of inter-regional trade.

2. TNSP revenue challenge

2.1. Nature of the challenge

AFMA sympathises with Energy Networks Australia's concerns regarding the impact of increased negative settlement residue costs on TNSPs cashflows and considers that the AEMC should explore options that address their concerns while preserving the value of SRA units.

AFMA considers that netting of negative residues is one of the less attractive options for addressing the TNSP concerns both because of the customer impact it will have as a result of the reduced utility of SRA units as hedging instruments, but also because it does not fundamentally solve the TNSPs' cashflow concerns. The proposed netting approach still leaves TNSPs exposed to the cashflow impacts caused by the volatility of negative residues, it just reduces the scale of the impact slightly for transmission loops. We consider that a number of the alternative options proposed by industry would better address the TNSPs' concerns without imposing the costs on the market and consumers that the proposed netting approach will.

2.2. Alternative options

AFMA considers that the AEMC's consideration of alternative options has been too limited and has not identify key components of some of the options. We think this is unfortunate as many of the options present the opportunity to address the concerns of both TNSPs and market participants without the negative market impacts and resulting increase in cost to customers of the AEMC's netting proposal.

The options AFMA considers deserve further attention are:

- **AEMO holding fund** – the paper dismisses this option out of hand on the basis that “it does not fundamentally address the problems of the draft determination” as the AEMC “has no reason to think that AEMO would necessarily be better placed to manage this risk than” TNSPs. While we agree that AEMO is no better placed than the TNSPs to manage market risk, the holding fund proposal does not require them to be. Instead, it addresses the core issue facing TNSPs around the timing mismatch in recovering negative residues. We consider that the key value of this proposal is to provide greater certainty about the calculation of TUOS charges.

TNSPs do not face market risk like market participants as they are able to fully recover the costs of negative residues through TUOS charges. The problem they face is a timing issue resulting from the AER needing to determine TUOS charges before the volume of negative residues becomes known. As a result, the AER has to estimate the volume of negative residues with TNSPs having to finance the cost of an under forecast until the next AER decision.

The purpose of the AEMO holding fund is not to manage market risk but to delay the recovery of negative residues from TNSPs to allow the AER to make their recovery retrospective. This would mean that the AER would no longer have to forecast negative residues as they would be able to base TUOS charges on the actual negative residues from the prior period. This would remove the risk that TNSPs currently have as a result of under forecasting.

AEMO is potentially better placed to perform this financing role than TNSPs as it is not subject to revenue regulation and therefore does not face the same regulatory challenges that TNSPs regarding allowances for financing costs. Having AEMO perform this role on a cost recovery basis could potentially also deliver a saving for consumers as, unlike a TNSP,

they would not expect to earn a profit from delivering this service and therefore customers would be spared the cost of TNSPs earning a regulated return on their financing costs.

- **Recovery from market customers** – The AEMC rejected this approach on the basis that they considered it would result in the costs being recovered from consumers and that it would impose a cost on retailers who did not use SRAs. As discussed at length in this submission, we do not agree with the AEMC that netting negative residues will result in a saving to consumers and consider it is appropriate that the full cost of providing electricity will be borne by consumers. We also think that it is incorrect to think that retailers would be able to directly pass on these costs as under both the national and Victorian retail price regulation frameworks, retailers do not directly recover spot prices costs. Under both frameworks, retailers recover the cost of hedging their exposure to the spot market, not the underlying costs of the market. As a result, there is no obvious mechanism for market customers to pass the costs directly to consumers.

We also think it is inappropriate to reject this approach on the basis that it would impose inappropriate costs on market participants who do not use SRAs without seeking feedback from the market. AFMA represents a significant cross section of both large and small market participants, and our membership is very supportive of exploring any options that preserve the value of SRA units. We also note that all market participants, regardless of size or location, can potentially benefit from the use of SRA units as a hedging tool and understand that many smaller participants do use them.

Ideally the AEMC should have consulted on alternative approaches throughout the rule change process but given this has not happened we think the only option open to the AEMC at this stage, is to implement AEMO's original proposal and to conduct a review to allow adequate time to address TNSPs concerns regarding the management of increased negative residues. While AFMA is sympathetic to the TNSPs' concerns, we do not consider that they need to be dealt with urgently and consider that a thoughtful review would be more appropriate than rushing changes now.

3. Concerns about the rule change process

The AEMC does not typically publish directions papers as part of the rule change process. Generally, most discussion of a proposal occurs in response to the initial proposal and the AEMC's draft decisions, which considers this feedback, gives stakeholders a reasonably clear understanding of the expected direction of the rule change. It is very unusual for the AEMC to make a major change of direction after publishing a draft determination unless new issues come to light and then the AEMC typically allows sufficient additional time for consultation on the issues raised by the new approach.

Based on the published submissions, AFMA does not consider that the submissions to the draft determination raised any substantial new issues that were unknown at the time the draft determination was published. Despite this, the AEMC has published a directions paper which essentially amounts to a second draft decision and gives the industry an unacceptable short period of time to respond to a complicated proposal that fundamentally changes the operation of the SRA.

We consider that the AEMC is now in a difficult position facing a short time frame to implement a contested set of reforms entirely as a result of its management of the rule change process. We want to be clear that AFMA considers that the issues raised by the TNSPs are legitimate and should have been considered as part of the rule change process. The AEMC did not consider them in their initial consultation paper or the draft determination and the lack of consideration of alternative approaches in the directions paper now leaves them in an unenviable position.

AFMA considers that as currently proposed, the rule changes will;

- increase consumer cost

- reduce market participants' ability to manage inter-regional risk and
- generally reduce the value of inter-regional trade.

We consider that the AEMC's current proposal should not be implemented and that there is now inadequate time to explore the issues raised by TNSPs adequately prior to the commissioning of Project Energy Connect. We therefore think the only option open to the AEMC is to implement AEMO's original reform proposal and to consider the TNSPs' concerns as part of a subsequent review.

AFMA Recommendations

- i. The AEMC should implement AEMO's original reform proposal.
- ii. There should be a review to address TNSPs concerns regarding the management of increased negative residues.

AFMA would welcome the opportunity to discuss this submission further and would be pleased to provide further information or clarity as required. Please contact me at lgamble@afma.com.au or 02 9776 7994.

Yours sincerely,



Lindsay Gamble

Head of Energy and Carbon