AFMA

17 October 2017

John Pierce
Australian Energy Markets Commission
PO Box A2449
Sydney South NSW 1235
(lodged online at www.aemc.gov.au)

Dear John,

Draft determination – Five minute settlement

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comment on the draft determination – Five Minute Settlement ("draft determination"). AFMA represents the common interests of its members in dealing with issues relevant to the good reputation and efficiency and competitiveness of wholesale banking and financial markets in Australia. Our members include Australia's major energy companies and other users of over-the-counter electricity derivatives.

AFMA has previously responded on the AEMC's directions paper in May 2017 and appreciates that the AEMC has considered our view in its draft determination. As noted in our Directions Paper submission, whilst acknowledging the overall purpose of the rule change request and the directions paper, AFMA's focus is on the efficiency and competitiveness of electricity financial markets.

Below is a summary of AFMA views which were provided in our submission, and additional comments on these views given the draft determination has been released.

Costs versus benefits

In our previous submission, AFMA's view was as follows:

AFMA agrees with the AEMC that ideally, a market where the price provides signals and incentives for supply to be responsive to demand over the shortest timeframe practicable will drive more efficient wholesale market outcomes. AFMA notes that the benefits that AEMC sees from the proposed change largely result from efficiencies in investments, bidding and operational decisions that would result from an improved price signal. We note however that the actual proposed benefit in the form of lower retail electricity prices *is largely theoretical, and will be dependent on actual participant behaviour once 5 minute settlement is implemented. The effect on retail electricity prices may be different over the short, medium and longer term.*

This theoretical expected long-term benefit must be weighed against the not insignificant expected costs that will be incurred by market participants, both initial and ongoing, in order for the AEMC to determine if there will be a material net benefit from the proposed change.

The AEMC acknowledged AFMA's view on page 22 of the draft determination. We note that the AEMC retains the view that aligning dispatch and settlement at five minutes would have significant enduring benefits which will quickly outweigh the one-off and any ongoing costs. However, we remain of the view that the actual proposed benefit is largely theoretical, and will be dependent on actual participant behaviour upon implementation.

Financial market liquidity

In our previous submission, AFMA's view was as follows:

In determining the overall costs of such a change, the AEMC should be particularly mindful of the potential negative effects on financial market liquidity of such a change, as well as the potential for increased prices in financial market contracts for an extended period of time. Whilst the AEMC's focus in the directions paper has been on the effect on liquidity and prices of the cap market in particular, we contend that the potential effect on swaps and futures is just as important and potentially will involve additional costs.

Given these potential negative liquidity and cost effects, AFMA suggests that the AEMC gives further due consideration and undertake further analysis with respect to this issue before making its draft determination.

The AEMC acknowledged AFMA's view on pages 47 and 48 of the draft determination. However, the concerns expressed in this view appear to have not been addressed in this determination. As per the directions paper, the AEMC's focus in its draft determination has been on the cap market in particular. The potential negative effects on financial market liquidity and potential for increased prices in financial market contracts has not been given the due consideration and further analysis that AFMA suggested.

Transition period

With respect to a transition period if implemented, AFMA member views are mixed in this regard, but most consider that a three year period is too short, and a longer period would be preferred.

The AEMC acknowledged AFMA's view on pages 106 and 107 of the draft determination, as well as the individual views of some members of AFMA which added support to our view. We note that the draft determination has set a transition period of three years and seven months, which is slightly longer than the three years suggested in the directions paper, but it is likely that this transition period would also be considered too short by the majority of AFMA members, for reasons you have noted in your determination.

Yours sincerely

M. Chadwick

Mike Chadwick
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