AFMA

21 November 2011

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South
NSW 1235

Dear Mr Pierce

**ERC0123 National Electricity Amendment Rule 2011**

In June 2011 the Australian Financial Markets Association (AFMA) provided a detailed submission on the AEMC Consultation Paper in which we recommended that the MEU proposal should be ruled out of further consideration as soon as possible. We note with disappointment the Commission's decision to proceed with an extended consultation process that will unnecessarily prolong market uncertainty.

The proposal has such significant shortcomings that a decision to dismiss it should be made now without undertaking any further investigation. The overall success of the NEM in terms of reliability and pricing has been clearly demonstrated over many years. The significance of the co-existence of a liquid derivatives market through which participants can manage their risks (including pool price spikes) should not be underestimated. The need to ensure continued timely infrastructure investment and the reputation of the market as not being subject to, or even considered for, radical regulatory change without justification, is critical to this outcome.

There is a perceived risk that the process being followed for the review of the MEU proposal may result in an outcome divergent to the original proposal under statutory consideration. The current process may benefit from an explication of the protocols being observed to ensure that perceived tensions are being appropriately addressed.

In regards to the definitional determinations made by the Commission we note that the AEMC has proposed "substantial market power" and consider this a more appropriate definition than "market power". We agree with the Commission's assessment that transient pricing power should be excluded from consideration by any definition adopted as it is consistent with a workably competitive market with constrained supply where episodes of high volatility are a design feature. This is consistent with the highly competitive outcomes that have been achieved by the NEM – including some of the lowest pricing in the OECD – where transient market power exists.

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In terms of the specific definition adopted by the Commission, in our view there is a risk of it being read too tightly. The reference to “annual average wholesale prices” may not be sufficient to ensure this is read as long term, given the timeframes for the creation of additional capacity in the energy market. While the Commission’s notes further explain that this may be “.. at least two to three years”, this information would have been better made explicit in the definition itself. Further we suggest that this may be on the low side considering the need for higher than LRMCs to be observed for a period of time by an investor before a decision could be confidently made to invest on the scale required, combined with the Commission’s noted timeframe for implementation for new capacity.

The Commission considers “…regulatory intervention is only potentially justified if there is evidence that a generator has exercised, *or is likely to exercise*, substantial market power”[emphasis added]. As noted on page 19 of the Directions Paper, past conduct cannot conclusively imply an ongoing problem which requires intervention.

We do not believe a major structural change in the operation of the NEM should be based on “… whether there is evidence of any *expected* changes in market circumstances which *may* mean that the exercise of substantial market power is either more or less likely in the future” [emphasis added]. This limitation is too broad and requires predictions of future developments and their implications for the market. The proposed next step by the Commission that it will determine if any generators have “exercised substantial market power in any relevant market, *or are likely to do so in the near future*” [emphasis added] is of concern.

By including the limitation “or is likely to be able” in the definition of the “exercise of substantial market power” the Commission risks denying the opportunity for the market to respond to above LRMC pricing by bringing forward additional capacity. Barriers to entry in a capital intensive industry such as energy will always to some extent be ‘significant’ but this does not mean they are necessarily impractical for a motivated investor.

Similarly, the Commission’s ‘temporal’ definition of the relevant timeframe of the market of “at least one year, and potentially two to three years” may be inadequate as it may be too short - particularly at the one year minimum - to reflect the concept of “long term” in the electricity market when consideration is given to allowing the market to signal the potential for new capacity to a rational investor and for extra capacity to be implemented.

The Commission’s acknowledgement that “there will be a degree of estimation required when calculating LRMC” may understate the difficulties and potential for error involved in calculating LRMC. Correctly calculating the LRMC is critical to the approach proposed by the Commission and it is essential that the inherent difficulties are clearly acknowledged.

The consideration of the relevance of NEM-wide changes for isolated issues, should they be identified, is also critical to ensuring an appropriate response. Patterns observed in one NEM region that can be demonstrated to be absent in other regions should be noted by the Commission as constituting a *prima facie* case for limiting any proposed changes to that market.

We are concerned at the statement on page 21 that the product market will not include derivatives which are considered “…not separate products, but are simply another means of expressing the price for electricity”. That assertion fails to recognise the fundamental role of derivatives (over-the-counter and on-exchange) in managing price risk in the electricity market.

The derivatives market provides a suite of products with deep liquidity which enables effective hedging against adverse pool price movements. These markets are available to end-users and we understand a number of major users actively manage their risks by buying swaps and caps. As well, fixed price contracts can be negotiated with retailers, who are able to lay off their resulting spot price risk using derivatives. A number of advisory firms exist which assist clients in maximising the benefits from hedging techniques.

The AFMA *2011 Australian Financial Markets Report* shows derivative market turnover in 2010/11 of some 863 million MWh against NEM demand of 192 m MWh. The liquidity ratio[1] of 4.5 is greater than that of Commonwealth Government Bonds. d-cypha/ASX offer futures and options across a wide range of products and in OTC markets swaps and caps accounted for 80% of turnover with solid activity in swaptions and collars & Asian options.

Given that these methods of efficiently mitigating the impost of pool price spikes exist, a user which chooses not to utilise them is making a conscious decision to remain exposed to price risk. That should not, as the MEU is proposing, lead to a major restructuring of the way in which the electricity industry operates.

Price spikes are inherent in the NEM design and mechanisms exist to efficiently hedge these price risks. The MEU proposal runs counter to the objective of the National Electricity Law and, if implemented, would have the perverse effect of increasing electricity prices because hedging capabilities could become limited. Generator sustainability could also be brought into question as revenue would be below efficient costs which would deter investment in generation capacity.

We reiterate the conclusion in our earlier submission that the proposal should be rejected sooner rather than later.

Yours sincerely

Allen Young
Director Rates & Energy Markets

[1] Defined as derivative turnover divided by turnover in the underlying market