INFORMATION

Short Term Forward Market draft determination

Stakeholder submissions invited on draft determination

The Australian Energy Market Commission (AEMC) has published a draft rule determination and decided not to make a draft rule to introduce a voluntary market for short term financial electricity derivatives in the NEM, as it considers it is unlikely this would contribute to the National Electricity Objective. Submissions are due by 6 February 2020.

Context and rule change request

On 20 December 2018 the AEMC received a rule change request from the Australian Energy Market Operator (AEMO) to amend the National Electricity Rules and introduce an exchange for short term forward contracts.

The rule change proposed a short term forward market (STFM) for electricity derivatives that would operate alongside the NEM and the existing financial contracts market. It would use a model similar to that of the AEMO-operated Gas Supply Hubs (GSH) including using the same platform (Trayport), and processes for clearing, settlement and prudential arrangements. Some specific characteristics of the market included:

- voluntary and anonymous trading
- exchange trading of standardised short term electricity derivative contracts
- contracts traded daily on a rolling basis for the following day and up to seven days in advance
- transaction prices and quantities published on the AEMO website.

AEMO suggested the STFM, if liquid, could:

- contribute to the reliable and secure supply of electricity by addressing potential barriers to demand-side participation, and creditworthiness and collateral requirements for smaller participants—providing more avenues for participation could lead to more efficient spot market outcomes and long term investments
- improve short term operational decisions of market participants in the face of volatile market conditions, e.g. holding a swap contract incentivises generators to be available when needed to earn revenue in the spot market to fund payouts on their contract positions
- support long term contracting by signalling market expectations of future spot prices, lowering the cost of financing investment in generation capacity and underwriting retailers' fixed price offers to end-customers.

Draft determination

If the benefits from the STFM for financial derivatives were to be realised by participants, the voluntary STFM would need to be liquid and traded on.

To understand the way that participants currently manage their risk and determine the underlying level of demand for short term hedge contracts, the Commission consulted widely, meeting with small renewable participants and new entrants, established vertically integrated participants, brokers, exchanges, and industry bodies.

The rule change proposal identified three groups of participants that may benefit from short term hedging, namely intermittent generators, demand response participants and gas peaking generators.

- Discussions with intermittent renewable generators revealed that there was mixed demand for short term financial firming products. Two larger participants stated that short term hedging products may be useful for optimising within their diversified generation portfolio.

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However, most other participants stated they preferred to manage their price risk on a longer term basis. Other products such as power purchase agreements, proxy revenue swaps and longer term solar and wind firming products were more attractive as they further reduce investors' exposure to risk and do not require an active trading desk.

- Demand response participants also showed little interest in short term financial hedging products. Participants noted that the likely clearing price of a short term derivative before a high priced event would be relatively high, reducing the effectiveness of the product.
- Almost all participants that own open cycle gas turbines (OCGTs or gas peakers) did not support the introduction of a STFM for electricity derivatives. Stakeholders told the Commission that, if required, short term portfolio optimisation can and does takes place through trading on the ASX. If participants want to buy or sell hedging in the short term, they will trade in and out of a cap contract for the current quarter. Participants noted that this only works as the quarterly contract market is the most liquid of all listed products.

The conclusion from the consultation and market analysis is that there is currently limited demand for short term hedge products in the market and that demand is sporadic and bespoke. Therefore, if introduced, the Commission believes a STFM for electricity derivatives would not be actively traded on and hence would not provide any investment signals, or materially improve short term operational decisions, and thus is unlikely to generate any material benefit to consumers.

Further, the Commission noted that market-led processes for establishing new financial products appear to be working. Typically, before an exchange lists a new product, there is evidence of that product trading more frequently on the OTC market. There is recent evidence of new products being developed and traded by brokers on the OTC market, such as solar shape products.

Other processes to improve the operation of the NEM

The Commission considers reforms to bring the national electricity market closer to a two-sided market have the potential to improve the accessibility of demand response and hence reliability and security, at a lower cost.

The AEMC is working with the Energy Security Board, AEMO and the AER to develop a high-level design for a two-sided and ahead marketplace, to be delivered to the COAG Energy Council in March 2020 as a priority. A move towards a two-sided market that actively engages load may require some form of ahead feature and this will be considered as part of this work.

Consultation process

Stakeholders are invited to provide written submissions on the draft determination by 5pm on **Thursday 6 February 2020**.

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