AGL Energy Limited
ABN: 74 115 061 375
Level 24, 200 George St
Sydney NSW 2000
Locked Bag 1837
St Leonards NSW 2065
t: 02 9921 2999
f: 02 9921 2552
agl.com.au

Prabpreet Calais

Australian Energy Market Commission

via the AEMC website

23 May 2019

Submission to Short Term Forward Market rule change – ERC0259

AGL Energy (**AGL**) welcomes the opportunity to comment on the Australian Energy Market Commission's (**AEMC**) Short Term Forward Market consultation paper (**Consultation Paper**).

AGL is one of Australia's leading integrated energy companies and the largest ASX listed owner, operator and developer of renewable generation. Our diverse power generation portfolio includes base, peaking and intermediate generation plants, spread across traditional thermal generation as well as renewable sources. AGL is also a significant retailer of energy and provides energy solutions to over 3.5 million customers in New South Wales, Victoria, Queensland, Western Australia and South Australia. We are active in energy market derivatives across the NEM.

The Australian Energy Market Operator (AEMO) has proposed this rule change following recommendations in the AEMC's Reliability Frameworks Review. While the focus of a short-term forward market (STFM) in that review was to facilitate greater levels of wholesale demand response that could contribute to greater levels of system reliability, the Retailer Reliability Obligation will now address reliability concerns. AGL understands the AEMC is instead more broadly interested in whether a STFM would assist any market participants with business risk. Particularly, whether these shorter-term products would be useful to gas-powered generators, intermittent renewable generators (ie wind), or electricity consumers, who may have a better idea of their expected electricity output or needs in the days leading up to dispatch and wish to lock in a price through a financial derivative.

Should there be sufficient benefits from these products to justify a STFM, the Consultation Paper is also seeking feedback on whether the STFM should be run by AEMO or a third party (such as the ASX or FEX). We note that the Reliability Frameworks Review raised the possibility of AEMO running the STFM as one of many options that could be considered through the rule change process, given the potential legal hurdles that would need to be addressed for AEMO to run the STFM.

Risk management options

Electricity derivatives are typically available in quarterly or annual contracts and traded months to years ahead of dispatch. Managing risk over the longer term enables both parties to hedge exposures by locking in prices and make business decisions based on those prices. Long term risk management can also be important for project financing, which is why power purchase agreements have been vital for certain renewable generators.

Monthly electricity derivatives are listed on the ASX, and short-term markets (e.g. monthly, weekly, day ahead) are able to trade via OTC markets. It is typically much more difficult to find counterparties for these shorter-term products. As the dispatch date approaches, more information is available and there is less forecast variance. It becomes less likely that parties have complementary risks and are able to agree a price. The expected price for one of the parties may be much closer to the potential costs of not entering the contract (eg being exposed to the spot price or an existing hedge position), making short-term hedging less attractive.

Generators can manage the costs involved in their variability in output though both financial and physical arrangements:

- Entering power purchase agreements.
- Entering more bespoke OTC contracts, such as weather derivatives, wind firming derivatives and solar shape products. These innovative products have developed to assist generators with risk management, but also providing a long-term risk or price certainty.
- Firming their output with complementary technology.

A generator can also choose to not hedge against spot price risk, or to leave some exposure. There is a trade-off between entering risk management arrangements (whether with complementary firming technology, or a derivatives contract) and the risk of spot price exposure. Each business has their own risk appetite and strategy.

We note that market customers are typically large and sophisticated. They can manage their spot price risk using similar methods as generators, such as installing backup diesel or other generation to use when spot prices are high, or reducing their demand when spot prices are high. Market customers are also likely to buy financial derivatives to manage spot price risk. While some will be required to obtain a financial licence to trade derivatives, others may be exempt from this requirement where they are managing financial risk that arises in the ordinary course of business and they are not seeking to speculate or profit from the trading. Another option for a market customer is to engage an Authorised Intermediary to arrange financial agreements on their behalf.

Most customers manage spot price risk by entering into an agreement with a retailer, which may include arrangements around demand response.

<u>Shorter term derivatives</u>

As noted above, AGL is unclear whether there is sufficient market demand for shorter-term derivative products, given the likelihood that the benefits of entering a short-term trade diminish as you approach the day of dispatch. While there may be some participants interested in offering these short-term contracts, we question whether there will be enough willing counterparties to create a liquid and viable market, particularly given the limited trading occurring in the monthly ASX listed contracts.

To demonstrate this concern with some examples:

1. A wind generator knows that its output will likely be high in 2 days' time and offers a short-term swap or cap. Other market participants may be aware that the spot price is more likely to be low on a day with good wind resources, and therefore there is a reduced incentive to buy this product from the wind generator (the risk associated with spot price exposure on that day will likely be low). As more information is known, either the wind generator will have to offer a lower price than desired, or the buyer will have to pay more than is desired, making agreement less likely.
2. A generator has sold a long-term cap agreement. Output is expected to be low in 2 days' time (either due to an outage or fuel issue). To avoid exposure under its existing cap agreement, it could try to

buy a short-term cap from another participant to defend that position. The generator would be required to pay the premium for the short-term cap, so this may only be attractive if the exposure (ie spot price) is likely to be very high. However, if the spot price is likely to be high, the generator may find it difficult to find a short-term cap product at a reasonable price.

Despite these concerns, we do acknowledge that this rule change process will help to identify whether there are a significant number of market participants that are interested in using shorter term derivatives for risk management, which will help to inform the potential benefits of a STFM.

We also note that the effects on spot prices are unknown when the Five Minute Settlement reforms commence in July 2021, and some participants may find it useful to hedge at short notice, even with a significant premium.

Finally, AGL notes that shorter term derivatives can be offered by derivatives exchanges, or through OTC markets, without a rule change, should there be adequate demand for those products. Given any market participants that are spot price exposed would likely already hold a financial services licence to trade derivatives, or be exempt from this requirement, we suggest the AEMC investigate why these products aren't already being traded.

<u>AEMO's role</u>

While AGL does not object to shorter-term derivatives being available to trade, we do question the proposal that AEMO would run the STFM.

AEMO's role is to operate electricity and gas markets and power systems across Australia. Complementary to this, it provides planning, forecasting and power system information and advice. These functions and powers are set out in the National Electricity Law and the National Gas Law.

Financial markets, on the other hand, are regulated by the Australian Securities and Investment Commission under the Corporations Act. Those that wish to trade or deal in financial markets or derivatives are required to obtain financial services licences or be exempt from this requirement. Financial derivatives are subject to stringent regulatory controls, margining and risk management.

While AEMO's role is to physically operate the energy markets, AEMO does deal in certain products and has obtained exemptions from the need to obtain a financial services licence with regard to these activities. For example:

- Settlement Residue Auctions in the NEM: participants can buy an entitlement to a proportion of the intra-regional settlement residue.
- Gas Short Term Trading Markets: the ex-ante market allocates participants with the right (but not the obligation) to deliver or withdraw gas. Actual payments are determined by actual volumes for delivered and withdrawn gas, multiplied by the ex-ante price and subject to variations.
- Gas Supply Hub: physical trades are subject to delivery netting by AEMO.
- Reallocation facility in the NEM: Participants can request AEMO to make matching debits and credits to their position, which usually represents an off-market financial commitment (a derivative).

In these circumstances, AEMO's role in providing "financial services" is incidental to its role in operating a physical energy market. The financial product is not standalone.

The STFM is different to these examples – it is a standalone financial exchange and is not an essential or integrated part of the NEM. Running the STFM and oversight of this market would require an appropriately experienced and licenced financial market service provider. We find it difficult to understand why AEMO would (or should) be granted an exemption from the need to obtain financial licences to run the STFM, when other organisations (such as ASX or FEX) need to be appropriately licenced to offer the same products.

Costs and Implementation

AGL considers the benefits of this rule change are currently unclear (and potentially low) given there may not be many counterparties for these products. We consider that if these short-term products are to be offered, it should be done in a cost-effective way. Implementing shorter-term derivatives through the existing financial markets (should there be demand for these products) is the lowest cost option and does not require a rule change.

Should the STFM be run by AEMO, AEMO’s powers may need to be expanded to allow this new function, which would require a Law change. It would need to secure financial licences (or exemptions) to run the exchange. It would also need to develop the capability to manage the market obligations and compliance associated with a derivatives exchange, which would be vital for its successful operation. We consider the implementation timeframes and administrative costs to be significant, given the vastly different role involved for AEMO.

The rule proposal considers that implementation costs could be minimised by using Trayport to run the STFM, which is currently used as the exchange for the gas supply hub, pipeline capacity trading market and day-ahead auction. Using these markets and Trayport currently involves annual membership fees, prudential requirements, as well as costs associated with the products traded. These participation costs are not likely to be insignificant for smaller participants. AGL considers that AEMO’s running of the STFM should not necessarily be viewed as a “low cost” option. We note that ASX also has an existing exchange that could be easily expanded to include these products.

Should AEMO run the STFM, the costs and risks are placed on market participants and ultimately consumers. While cost recovery would primarily be through Trayport user fees, should the STFM be unsuccessful the costs would eventually be recovered from all market participants. On the other hand, if these products are offered by a competitive trading exchange and are unsuccessful, that trading exchange would bear the costs and risks of developing those products.

The prudential requirements across electricity and gas markets can be a significant cost of participation. Minimising these requirements in a way that doesn’t place unnecessary risk on AEMO may assist smaller participants in these markets. One of the proposed benefits of AEMO running the STFM would be streamlining and minimising prudential requirements across different markets. However, there may be other options to minimise prudential requirements without AEMO being directly involved in derivatives trading.

Under AEMO’s reallocation facility, participants can request AEMO to adjust their position with matching debits and credits, which typically reflect off-market financial agreements. As this demonstrates their exposure to the spot price is limited, AEMO reduces their prudential obligations. Currently, swaps, caps and floors can be reallocated in the NEM. Through this rule change, AGL suggests the AEMC consider the role of reallocation, which could help to reduce costs involved in physical market participation. For example, the types of agreements that can be reallocated could be expanded to include a wider range of OTC contracts that are becoming more widely used by participants with variable generation or load to manage risk. AEMC could also investigate the requirement that participants must be “wholesale clients” under the Corporations Act to use the reallocation facility, which may be preventing certain participants from using the facility.

Finally, we request that the AEMC consider the interactions between this rule change and other market reforms. In particular, the Retailer Reliability Obligation will require hedging a year in advance. This seems at odds with a STFM as we consider it likely there will be even fewer counterparties that find themselves unhedged and wanting to trade.

Conclusion

While AGL questions whether shorter-term derivatives will have adequate counterparties to deliver liquid products, we do not have concerns with these products being available to trade. These could be facilitated now or in the future through the ASX (or FEX), if there is adequate demand.

AGL has concerns with the proposal that AEMO would operate a derivatives exchange. While AEMO has obtained exemptions from the need to obtain financial licences in the past, we do not consider it appropriate in this circumstance. We consider the STFM to be outside AEMO’s purpose, which is to operate the energy markets, and this would be duplicative with the existing exchanges regulated by ASIC.

If you have any queries about this submission, please contact Jenessa Rabone on (02) 9921 2323 or JRabone@agl.com.au.

Yours sincerely,

Chris Streets

Senior Manager Energy Markets Regulation