SHORT TERM FORWARD MARKET (ERC0259)

Response to AEMC consultation paper

May 2019

1. Introduction

Stanwell appreciates the opportunity to provide feedback on the Australian Energy Market Commission's (AEMC's) Short Term Forward Market (STFM) Consultation Paper.

Stanwell is concerned that the rule change proposal does not clarify the issues that require the introduction of a STFM, so stakeholders are unable to evaluate whether an STFM is the best option for addressing the problems.

Stanwell and other market participants already trade short term contracts, directly or through brokered matching. Anecdotal evidence is that demand for such products is infrequent and typically opportunistic, and that unmet demand for short term contracts is insufficient to justify the cost of establishing an AEMO-operated STFM as proposed.

Stanwell suggests that the AEMC undertake further investigation into the product gap an STFM would address, the costs of establishing an STFM for market participants, as well as the considerable regulatory, licensing and governance considerations associated with any party (not just AEMO) implementing an STFM.

Stanwell welcomes the opportunity to further discuss this submission. Please contact Evan Jones on (07) 3228 4536.

2. Problem not identified

Stanwell's primary concern with the rule change request is that the issues that an STFM will address are not identified. This means that stakeholders cannot assess whether an STFM will be of any benefit to market and customer outcomes or simply add cost and complexity.

Once the problem has been identified and specified, Stanwell suggests the AEMC follow a decision process similar to the one depicted in Figure 1, to determine whether an STFM is required, the type of market and who should operate it.

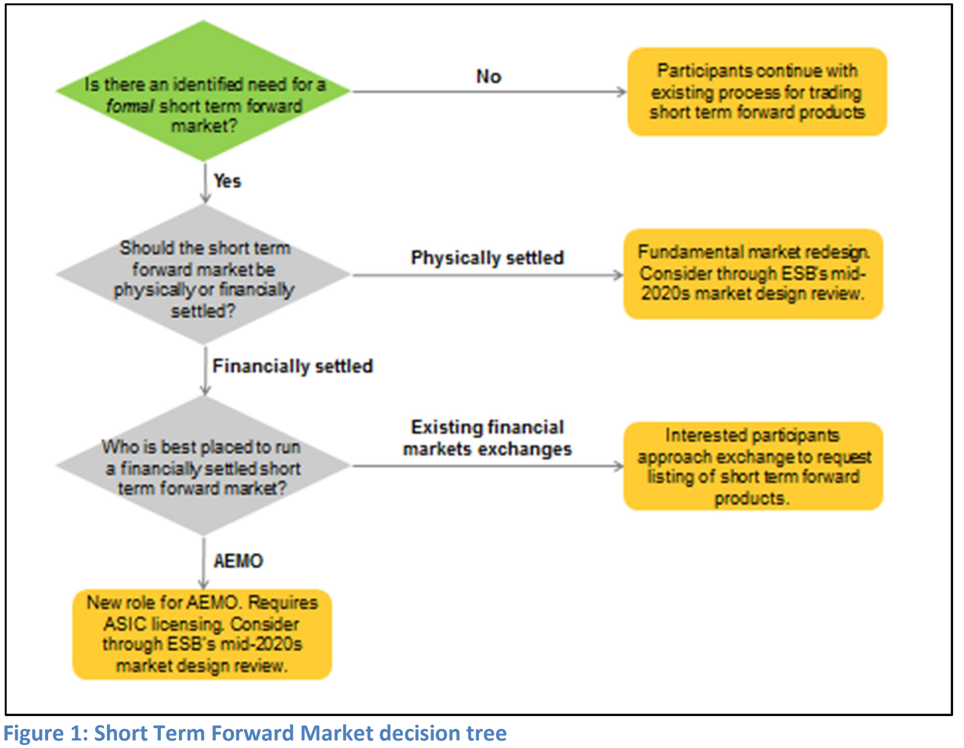

Figure 1: Short Term Forward Market decision tree

Interaction with other rule changes

There are a number of other significant market rule changes either being implemented (Retailer Reliability Obligation (RRO), Five Minute Settlement) or considered (Demand Response Mechanism, Coordination of Generation and Transmission Investment, Post 2025 Market Design for the National Electricity Market). How an STFM would be impacted by, and interact with, each of these changes needs to be considered when assessing the introduction of an STFM.

For example, the RRO aims to bring hedging forward (with retailers and large liable entities required to secure sufficient qualifying contracts by T-1) as a proxy measure for ensuring that sufficient capacity is available to support reliability. The introduction of an STFM may result in decreased demand for long term contracts. In the United Kingdom, the day-ahead market is highly liquid, but there is very limited longer term hedging. If the introduction of an STFM saw a similar shift in hedging, this may negatively impact the economic viability of scheduled generation, potentially affecting system security and reliability.

Also the Coordination of Generation and Transmission Investment review may recommend new pricing nodes thereby splitting liquidity and possibly undermining the benefits of an STFM.

The extent to which intermittent participants will be able to participate in an STFM may be curtailed by the RRO implementation. The consultation paper considers two uses for an STFM – adding hedges in the short term and buying back short term components of long term hedges. The RRO firmness guidelines will likely limit the volume of long term contracts intermittent energy generators can sell (although potentially only for generators who are also Market Customers). It is not clear why encouraging standalone intermittent generators to sell hedges above their firm equivalent would be of benefit to the market overall.

It would also be a perverse outcome if merchant intermittent renewable generation was encouraged to sell more firm hedges when vertically integrated intermittent renewable generation was restricted from being credited.

3. Product gap

It is not clear what product gap the proposed STFM would address.

Stanwell and other market participants already trade short term contracts, directly or through brokered matching. Anecdotal evidence is that demand for such products is infrequent and typically opportunistic, and that unmet demand for short term contracts is insufficient to justify the cost of establishing of a STFM.

If there was a large volume of interest in short term contracts, it would be expected that exchange traded products would have naturally developed to meet this unmet demand. This has not occurred suggesting there is insufficient unmet demand to warrant the costs of establishing these products.

Stanwell suggests the AEMC investigate if there are any impediments to short term trading now (such as the process and cost to list, the volume/fee required to break even etc.) and whether they would apply to the proposed AEMO-operated STFM.

Cost of credit

OTC markets usually operate with pre-agreed terms and conditions between counterparties which include the provision of or allowance for some form of credit support. Credit support may take the form of fixed dollar value bank guarantees or a Credit Support Annex (CSA) which requires the posting of more or less collateral depending on the mark-to-market movements of the underlying trades between the parties.

Exchange traded products are also costly (from a credit perspective) to participants, especially small participants. To trade in a listed product, parties must post an initial margin then a daily variation margin based on movements in the underlying product. Volatility is particularly problematic for credit constrained players as margin calls can be significant.

Consideration of the difference in credit costs between exchange traded and OTC markets should form part of the analysis for the rule change. It is possible that exchange traded markets are not cheaper than OTC markets. Stanwell's observation is that small entities often prefer to trade OTC where they can negotiate favourable credit terms.

Products listed

If a formal short term forward market were to proceed, a decision would need to be made on what products to list. Usually products evolve initially through the Over the Counter (OTC) market before being formalised, in response to trader demand, on exchanges. It may be best to observe some period of OTC activity before formalising the listed products. Sometimes the "logical" products (such as monthly, solar and wind products) show little liquidity whereas bespoke products (such as average rate options) are more liquid.

Short term contract tenor

Additionally, the proposed beneficiaries of an STFM (intermittent energy generation, gas-fired generation and demand side participation) would most likely require tenors shorter than the daily contracts[1] proposed in the rule change. For example, wind and solar resources can vary widely over a day, gas-fired generators would be expected to seek contracts that are granular enough to align with their minimum run times and forecast high price periods, and there are limits on the length of time some demand side participants can reduce their load (e.g. aluminium smelter pot lines, behind the meter batteries).

4. Governance

Licencing of exchanges

Stanwell understands that entities operating as exchanges for financial market products must be licenced by the Australian Securities and Investment Commission (ASIC). We understand this to be an onerous and time consuming process which aims to ensure the integrity of Australian financial markets. Stanwell supports this rigorous licensing approach.

We also understand that the Council of Australian Governments (COAG) may have the power to intervene in the licencing approvals process and offer an exemption to licensing for a body such as AEMO. Stanwell does not support this approach as this undermines the licensing process and gives special treatment to AEMO at the expense of private initiative.

AEMO's core business

Stanwell also notes the numerous physical market challenges AEMO is facing through the energy market transition. We also note AEMO's significant work program on forecasting as a result of the Retailer Reliability Obligation. We would prefer that AEMO's resources and physical market expertise be channelled to resolving these issues of core business before implementation of a short term forward market.

5. Key design issues

In the event that an STFM is advanced, Stanwell suggests the following design elements be considered.

Financial market

The AEMC's Reliability Frameworks Review recommended a short term forward market for financial products[2], but the rule change proposal appears to consider

[1] Rule change request, page 4.

[2] Reliability Framework Review Final Report, page 46.

both financial and physically settled design elements[3]. A financially settled market would be preferred as it could be incorporated into the existing market structure and would allow financial participants (important for market liquidity) to enter the market. Conversely, a physically settled contract would require a fundamental market redesign and would preclude financial participants.

Implementation costs

Stanwell supports the AEMC's focus on potential implementation costs and the appropriate recovery of those costs from participants and, ultimately, consumers. AEMO comments in the rule change request that "[a]n AEMO-operated STFM is expected to be relatively low cost for AEMO to implement and for participants to trade on"[4] requires further analysis. Given the design of the proposed STFM has not been finalised, and the costs of current AEMO processes (e.g. 5 Minute Settlement and Global Settlement) have increased over time[5], this assertion requires proper evidence.

As part of this analysis, the cost of AEMO operating an STFM needs to be compared with market options. The ASX and FEX are already licensed, so the marginal cost of listing short term electricity contracts may be lower than the total costs of AEMO becoming licensed to deal in financial products, as well as the establishment and ongoing costs of running a new short term market.

Timing

If a formal short term forward market were to proceed and require alteration to AEMO and participant systems, it should be timed in a way that does not distract from the timely implementation of Five Minute Settlement (and global settlement).

Stanwell understands that AEMO's timelines are already very tight. It is unlikely to be efficient for Information Technology (IT) resources at AEMO and industry to begin work on a short term forward market until Five Minute Settlement is delivered.

The AEMC also needs to be satisfied that there is value in initiating another significant market change ahead of the Energy Security Board's mid-2020s market design review.

6. Stanwell's preferred approach

Stanwell suggests that the AEMC (and AEMO as required) investigate the regulatory, licensing and governance considerations of an STFM being implemented by any party (not just AEMO). In the event this is not resolved, it should not be assumed that the default position is that AEMO would run any potential STFM. AEMO's role is to operate gas and electricity markets. The private sector will continue to provide financial markets for market participants and other financial players.

Stanwell also suggests the AEMC investigates the issues an STFM would address, principally whether there is or is expected to be a product gap for short term electricity contracts in the market. This is likely to require deep engagement with the financial regulator (ASIC), existing licensed exchanges (both ASX and FEX) and the Australian Financial Markets Association (AFMA). Greater clarity should also be sought on relevant AEMO systems and processes such as prudentials and reallocations.

In the event that participants identify a need for short term contracts, the existing process of participant-led development of contracts (both OTC and exchange-listed) appears adequate.

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[3] Rule change request, page 5.

[4] Rule change request, page 14.

[5] 5 minute settlement estimate was $10-15 million up front plus $2-7 million ongoing. Global settlement estimate was $5 million. AEMO's February 2019 estimate is $121 million over 10 years (EF no 4 meeting pack).

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