13 November 2019

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

Dear Ms Boddington,

COGATI Proposed Access Model – Discussion Paper

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comment on the COGATI Proposed Access Model – Discussion Paper.

AFMA is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets. 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. AFMA has more than 120 members reflecting the broad range of participants in financial markets, including Australian and international banks, leading brokers, securities companies, fund managers, energy companies and industry service providers.

Whilst acknowledging the overall objectives of the discussion paper, and the several purported benefits of the access reform, AFMA's focus is on the efficiency and competitiveness of electricity financial markets. Accordingly, our comments are limited to those areas that relate to this focus.

As you would be aware, AFMA has previously made comment on your March 2019 consultation paper (COGATI Implementation – Access and Charging), as well as your June 2019 directions paper (COGATI Access Reform – Directions Paper). In both our submissions, and in several submissions by individual AFMA members, our key concern relates to the potential detrimental effects of the proposals on financial market liquidity. Given the content of this discussion paper, we continue to hold that concern. Furthermore, given that the proposed access model represents such fundamental reform if implemented, we believe the AEMC should consider implementation timing which is

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commensurate with the significance of the proposed change, and a detailed cost-benefit analysis of the change before a decision on implementation is made.

Financial market liquidity

The AEMC in the discussion paper has taken the view that the proposed changes would improve contract market liquidity, both within regions, but also across regions, given that parties will be able to better manage the risk of congestion by purchasing financial transmission rights, as well as better managing risks of contracting with counterparties in different parts of the NEM.

This appears to be a simplistic and optimistic viewpoint on financial market liquidity taken without due consideration to the considerable number of changes that the proposed access model is introducing, including:

- The introduction of Local Marginal Prices (LMPs) for scheduled market participants
- The introduction of financial transmission rights (FTRs)
- Proposed adoption of VWAP pricing for regional reference prices.
- Timing implementation

Each change above introduces considerable uncertainty for market participants, and consequently has the potential to detrimentally impact market liquidity.

Local Marginal Pricing

The first element of AEMC's model proposes that scheduled parties, such as generators and storage, receive a local marginal price (LMP) that more accurately represents the marginal cost of supplying electricity at their location in the network. At the same time, retailers and non-scheduled market participants would continue to be settled at the common regional reference price (RRP), in order to support liquidity in the forward market (page iv).

An inference from the last paragraph is that a shift to a local price for approximately one half of the market (i.e.; scheduled parties) does not support forward market liquidity. Generators and storage would be exposed to the fluctuations in local prices rather than the regional prices that retailers are exposed to. This is a fundamental change to these firms' financial risk profile and, all other things being equal, is likely to have a detrimental effect on market liquidity, by virtue of the additional uncertainty that this creates alone.

On page 35 of the discussion paper the AEMC dismissed the idea of full nodal pricing as the concept of a regional reference price facilitates contracting around a common wholesale market price at which all load and generation is settled, and hence regional reference prices support liquidity in forward contracts. AFMA agrees with this viewpoint.

The vast majority of forward contracts in Australia's electricity market (both exchange-traded and over-the-counter) use the RRP as the reference rate upon which these financial contracts are settled. By having only a handful of separate reference rates on which financial contracts are based, contracts are able to be effectively standardised and hence more liquid. The introduction of LMP pricing represents a departure from the RRP concept for a significant component of the market.

For generators/storage, who would be exposed to different future prices under this proposal (i.e.; the LMPs), the attractiveness and utility of standard forward contracts based on RRPs is clearly lessened as they will no longer be exposed to the RRP.

Generators may look to manage this new risk of future LMP volatility in a number of ways, including:

- Enter into new forward contracts based directly on LMPs rather than RRPs – this would be the most efficient form of hedge.
- Enter into new forward contracts which offset the difference between the LMP and the RRP (known as basis swaps) to transfer their financial risk back to the RRP.
- Purchase Financial Transmission Rights as suggested by the AEMC.

To the extent that the first option is pursued, this would detract from the natural provision of liquidity in the RRP-referenced contract market, as there would be a lesser requirement on the part of generators and batteries to hedge via the standard RRP referenced contract market. The second option would have the benefit of transferring the financial risk back to the RRP, but the likely availability of such contracts is limited.

The third option, which is the AEMC's solution, introduces additional uncertainties (see below).

Financial Transmission Rights

The second element of AEMC's model proposes to enable scheduled market participants exposed to the LMP to better manage the existing risks of congestion and transmission losses by enabling them to purchase financial transmission rights (FTRs). These products will hedge against the price differentials that arise under dynamic regional pricing. These rights are in effect options in which payouts occur when the LMP is lower than the RRP.

The AEMC's argument appears to be that the availability of FTRs will fully mitigate the negative liquidity risks associated with Local Marginal Pricing described above, and in fact, improve contract market liquidity. The AEMC's argument is that parties will be able to better manage the risk of congestion, and better manage the risk of contracting for electricity counterparties located in different regions of the NEM. The AEMC argues that generators currently sell a lower amount of hedges in the wholesale market than their physical capacity due to the risk of congestion, and given that the purchase of FTRs will help to manage this risk, ultimately generators will likely enter into more hedges and hence add liquidity. We consider this argument to be an untested theory, and consider

that it is the more likely that the marginal benefit of congestion risk management is more than outweighed by the other negative liquidity impacts of the changes.

We are uncertain how generators will respond to the existence and availability of FTRs in terms of liquidity provision. This will depend on their analysis of the risks associated with the availability and "firmness" of the FTRs.

FTRs are to be sold through a series of auctions run by AEMO over a three-year period. It is reasonable to expect that results in the FTR auctions will influence market participant behaviour both in subsequent auctions and in the contract market. For example, if one generator manages to win all the FTRs in the first few auctions, it is more likely that they will hedge their future financial exposure now that they have this transmission right. Conversely, if a generator misses out in the earlier auctions, they may be less likely to hedge their future financial exposure. Consequently, the actual impact on overall financial market liquidity is difficult to predict. Furthermore, timing of participant behaviour (and hence liquidity provision) in the contract market may be influenced by the timing of the auctions themselves, as they may be more inclined to hedge soon after a successful result in an auction.

The FTRs as they are currently defined are scaled back if there is insufficient funds available in the AEMO residue fund. In other words, they are not "firm" hedges of a specific volume of output. This adds an additional element of financial risk for generators and storage who would look to purchase these rights as they could not be confident of a full payout of the price difference between the LMP and RRP on a specific amount of generation or load.

Proposed adoption of VWAP pricing for regional reference prices.

The AEMC have noted that the regional price would preferably be the volume weighted average price (VWAP) applicable to unscheduled demand and supply within the region. Whilst we acknowledge the potential benefits of a VWAP approach, a change to a VWAP methodology could affect contracting market behaviour of all market participants, not just those exposed to the MRP. This is another potential liquidity risk factor.

A change to the calculation of the RRP is a significant change to the standard reference price for the contracting market. Consequently, all participants may reconsider their financial market risk practices if this were to occur. For example, without historical data on the performance of the VWAP RRP, proprietary market traders, who provide additional liquidity to the market, may be less likely to take on market risk. Similarly, all generators and retailers would be exposed to this issue, and may alter their hedging behaviour accordingly. If there is a significant change in the calculation of the RRP, this could cause contract frustration for existing OTC contracts. For example, the change may constitute a Market Disruption Event under ISDA-based OTC contracts, such as a Price Source

Disruption or Material Change in Formula. This could result in contracts having to be renegotiated, and potentially standard documentation rewritten.

Timing implementation and cost-benefit analysis

We note that the AEMC considers that July 2022 is appropriate for implementation of dynamic regional pricing and financial transmission rights. We contend that, given the significance of the changes, and the potential liquidity implications of the proposed changes, this timing is significantly shorter than optimal.

The further out the implementation date is determined, the less likely there will be current outstanding contracts affected by the change (minimising contract frustration), and the greater likelihood of market preparedness. This will also help ensure that any negative liquidity implications of the proposed model would be mitigated as practically as possible. Whilst we have no consensus from members on an optimal time, we suspect that they will give you further guidance as to optimal timing in their own individual submissions.

We note that in your previous Directions Paper that you stated that there "may be a risk of splitting liquidity in the contract market", and that the AEMC is "investigating this issue as part of its broader analysis on the implications of dynamic regional pricing for contract market liquidity." It appears that a full cost-benefit analysis of these significant reforms has yet to be undertaken, and we strongly recommend a full cost-benefit assessment process to ensure that the impacts on contract market liquidity are fully taken into account prior to determining whether or not to implement such a fundamental reform.

Please contact Mike Chadwick by email mchadwick@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

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