AFMA

9 June 2021

Dr Kerry Schott AO
Chair
Energy Security Board

By email: info@esb.org.au

Dear Dr Schott

AFMA Response to P2025 Market Design Options Paper

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Energy Security Board (ESB) *Post 2025 Market Design Options Paper* released on 30 April 2021.

AFMA is the leading industry association promoting efficiency, integrity, and professionalism in Australia's financial markets, with 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. AFMA represents the common interests of its members in dealing with issues relevant to the good reputation, efficiency and competitiveness of wholesale banking and financial markets in Australia.

As with our response to the September 2020 consultation, our comments are limited to those areas most relevant to the efficiency and competitiveness of electricity financial markets.

As we have previously raised, the proper functioning of financial markets (or contract markets) is critical to effective risk management for market participants. The use of derivative contracts such as swaps or caps to hedge against spot market risks to avoid exposure to volatile prices plays a significant role in determining ongoing financial outcomes for market participants. We note that some of the proposed changes would significantly disrupt these markets if implemented. Accordingly, we would like to take this opportunity to reiterate that the role of the contract markets needs to be properly considered in the development of these initiatives.

While additional feedback responding to specific consultation questions is set out at **Attachment A,** our main comments are as follows:

1. **Resource adequacy**

We understand the ESB is considering ways to strengthen investment signals to provide for better certainty around investment of new capacity and the exit of thermal coal generation, to ensure the long-term adequacy of resources in the NEM. Whatever mechanisms are implemented, the ESB needs to consider how reforms could assist with providing enduring certainty to both investors and governments.

AFMA is broadly supportive of ESB coordination of jurisdictional investment schemes to ensure forward certainty for governments and market participants. The coordination of information provision between jurisdictions, and establishment of agreed national principles to inform the design of government long-duration contract schemes will help ensure consistency across the NEM and reduce the uncertainty created by a fragmented approach.

In terms of changes to the Retailer Reliability Obligation (RRO), there are a range of areas that the ESB will need to conduct further analysis on before proceeding further.

- It is unclear whether a modified financial RRO will be able to provide sufficient long-term signals necessary to drive investment, as the efficacy of a modified RRO (with the removal of the T-3 trigger) is still dependent on the willingness of market participants to enter into longer-term contracts, something which is difficult to assess in the current uncertain environment.

- The creation of a physical RRO certificate scheme may provide additional signals to the market, however there are a number of issues the ESB will need to consider in the design of a scheme, as its ability to incentivise investment in new generation ultimately depends on how it is designed and regulated and when it is put in place. As it is less flexible than a financial RRO, the introduction of a certificate scheme will increase the regulatory burden on market participants (particularly non-vertically integrated retailers).

- It will be worth assessing the potential impacts of the introduction of a physical RRO certificate scheme on contract market liquidity, although participants will continue to use derivatives to hedge spot market risks.

The RRO provides a relatively indirect means of facilitating new investment. Whatever decision is made to modify the RRO will need to be carefully considered, given the relative high implementation costs associated with a physical RRO with no guarantee of providing long term investment signals. At this stage it is not clear how changing the nature of the RRO can ensure the requisite level of investment will occur in a timely manner or provide sufficient certainty to government.

2. **Essential system services (ESS), scheduling and ahead mechanisms**

As a range of important ESS mechanisms are currently being developed under AEMC rule change processes, we do not have much in the way of comments to provide here, other than that the AEMC will need to understand how these mechanisms will effectively work together in practice. Appropriate coordination of mechanisms will be necessary to ensure efficient outcomes and reduce any negative impacts to participants in the system.

With respect to the development of an operating reserve, we understand that AEMC will consult on a draft determination on the *Operating reserve market* and *Introduction of ramping services* rule changes mid-2021 which may provide some further detail on what is under consideration. We note that any operating reserve mechanism will need to be designed in such a way to provide a sufficient forward signal to incentivise the generation investment necessary for future needs, allowing participants to form expectations around prices to be able to hedge risks accordingly.

In our previous submission, we were not supportive of the development of day-ahead markets given that the financial market provides for this already and the implementation of an ahead market would provide little benefit to market participants. We remain of the view that the development of any ahead market should wait until the more immediate reforms are developed to determine if there is an actual need.

3. **Integration of Distributed Energy Resources (DER) and Demand-Side Participation**

At this stage AFMA does not have comments to provide in response to the options outlined for integration of DER and demand-side participation. As with the ESS mechanisms, the ESB will need to ensure that the development of mechanisms can be appropriately coordinated to minimise system implementation costs on participants and the market operator.

4. **Transmission and access**

We acknowledge that the make-up of the generation landscape is changing and understand the need to assess transmission and access frameworks and invest in network infrastructure, to accommodate the introduction of a large volume of new generation to the grid. Accordingly, we are generally supportive of the following developments:

- ***Actioning the Integrated System Plan (ISP)*** – the central planning provided by the ISP allows the market to determine best locations for generation investment, including Renewable Energy Zones.

- ***Developing Renewable Energy Zones (REZs)*** – a REZ framework integrated with the ISP and other effective mechanisms will assist in coordinating new investments. We understand that a means to appropriately share costs of connection between participants is also required to cover the financial outlay associated with building new transmission.

- ***Enhancement of the Congestion Information Resource Guidelines and market information*** – AFMA is supportive of increased transparency around existing and forecast congestion, as well as network hosting capabilities and timing, location and size of intended connecting generation as a way to improve locational signals.

The April Options Paper provides an overview of several interim models for transmission access reform. AFMA and members believe that there is insufficient detail provided to enable participants to determine which option is preferable. We are also concerned that the paper does not clearly explain what the interim model ultimately chosen needs to achieve, given that each of the models appear to address different (albeit related) issues.

We remain concerned that the long-term plan for transmission and access reform involves the introduction of the locational marginal pricing (LMP) and financial transmission rights (FTRs) model proposed by the AEMC. Our submission to the 2020 Directions Paper outlined the significant detrimental impact the model would have on contract market efficiency and liquidity. We also raised a range of issues with the NERA cost-benefit-analysis, in that it set out unreliable assumptions of what would result from the introduction of LMP/FTRs and how participants would behave, including an insufficiently substantiated claim that contract market liquidity would increase under the model. We note that the overwhelming majority of submissions made in response to the ESB Directions Paper did not want the model to go ahead and advocated for the development of alternative solutions. As a result, we consider any plan to develop an interim access framework as a 'steppingstone' to LMP/FTRs to be misguided.

The implications of any interim models on contractual arrangements need to be fully considered prior to any option being developed. We suggest that further consultation with industry is conducted and more detailed information is provided on each model to enable participants to assess potential impacts.

The ESB asserts that current financial outcomes will be broadly replicated under models based on the congestion management model (CMM), however this will not be the case for all participants. The options also do not address material concerns around the LMP/FTRs approach. To illustrate, the relative firmness of FTRS has consistently been raised as a concern with the AEMC proposed model. The CMM rebate will face the same problem, with the lack of firmness exposing generators to price and volume risk and reducing revenue certainty. This is expected to affect generators contracting activity with respect to the Market Liquidity Obligation (MLO) tied to the RRO, as well as contracting activity more broadly. As a consequence, this may lead to a reduction in retail competition and increase the risk of higher retail prices for consumers.

Issues related to contract disruption are of major concern and these will need to be considered before developing interim models further. There is a significant risk that any participants negatively impacted by the introduction of the CMM will not be able to open existing contracts to renegotiate. This is because the regional pricing arrangements will be retained, and there is a possibility that the changes brought about by the interim model would not amount to a 'Disruption Event' under an ISDA agreement, which would have allowed the opening of a contract for negotiation. Accordingly, if any interim model is implemented, the ESB needs to ensure that it is explicit to market participants whether or not the changes meet the threshold to amount to a disruption event, so that those disadvantaged by changes are able to manage affected contracts.

Given that the implementation of interim mechanisms will have a range of costs associated and will require application of significant resources to design and execute, it remains unclear whether the risks related to creating and subsequently disrupting an interim mechanism in order to implement LMP/FTRs have been assessed. Market participants will need to plan for the transition of contractual arrangements to prepare for whatever interim solution is devised. This work will need to be repeated if the long term LMP/FTRs model is implemented. The prospect of an interim model put in place in 2024 being replaced by a new model in due course creates a high degree of uncertainty which is likely to result in participants not being able to appropriately manage risk positions and plan for new investment.

Before proceeding further with transmission access reform, the ESB should consider in detail the benefits of any changes alongside their relative cost, complexity, and impact on contract market liquidity. We note that the impact associated with the implementation of the 5 Minute Settlement Rule Change was underestimated. The implementation of transmission access reform will not be any simpler, especially where a novel temporary change to transmission access, with its own implementation costs associated, is expected to be replaced within a relatively short timeframe by another complex model.

The rushed implementation of comprehensive changes without proper impact analysis (from a spot market and financial contract market perspective) will result in negative implications for participants across the NEM with flow-on effects to consumers. It is important that market participants are able to manage risks and costs associated with the introduction of new mechanisms to ensure the ongoing security and reliability of the electricity system.

Thank you for the opportunity to comment on the reform options proposed. Please contact me either on 02 9776 7979 or by email at nthompson@afma.com.au if further clarification is desired.

Yours sincerely

Natalie Thompson

Policy Manager

Attachment A – Responses to Consultation Questions

1. Resource Adequacy Mechanisms

#	QUESTION	COMMENTS
2	Which financial principles are most important in establishing means to integrate jurisdictional investment schemes with market arrangements as smoothly as possible?	Further engagement with stakeholders and seeking coordination with jurisdictional investment schemes on high-level principles is sensible.
3	Are there financial principles missing, or that have been included but shouldn't be?	We generally agree with making contracts responsive to market signals provided that there is a sufficient level of certainty long term to allow for appropriate risk management.
10	How can governments, market bodies and market participants better work together to be prepared for exits?	Government/regulator coordination at the state and federal level is necessary to increase certainty across the NEM for market participants.
16	Would one RRO option over another better suit particular types of market conditions anticipated over the course of the transition?	It is unclear whether either is going to provide the level of certainty required to make efficient investment decisions (though the modified financial RRO would be able to be implemented earlier).
17	*[Financial RRO option]* How could you strengthen the signal? Could minimising the triggers do this? What are the unforeseen consequences or implications with this?	Whether modified RRO without T-3 trigger is sufficient to bring about significant new investment still depends on the appetite of market participants to enter long term contracts and positions.
22	*[Physical RRO option]* How would a physical RRO impact contract market liquidity?	Depending on how it is designed the introduction of a physical RRO may have a disruptive impact on contract market liquidity. However, under the certificate scheme proposed, market participants would still use contract markets to hedge exposure to spot price volatility, so we do not believe there will be material impacts to liquidity in contract markets.
23	*[Physical RRO option]* What other impacts on small retailers and C&I customers need to be considered? How can they be best mitigated?	As noted in the options paper the physical RRO comes with higher implementation costs and an increased regulatory burden to participants. As noted, a physical RRO may disadvantage non-vertically integrated retailers, potentially impeding their ability to compete for C&I customer demand. This can be mitigated to an extent by ensuring sufficient liquidity in any market that trades certificates.

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4. Transmission and Access

#	QUESTION	COMMENTS
43	Does the proposed reform pathway for transmission and access meet the needs of the transition?	At this stage it remains unclear what the planned reform pathway will entail. As outlined, there are real concerns with the plans to implement an interim model which will be subsequently replaced in a relatively short timeframe by the LMP/FTRs model.
44	For each medium-term access option presented in Part B: • *Do you think that the model satisfactorily addresses the access reform objectives set out above?* • *If any, what is your main criticism of the model?* • *What additional detail do you require to understand the option?*	These are not simple, straightforward changes and will require the application of significant resources to implement from a market design perspective, and from a trading participant perspective. We understand the ESB has indicated a preference for hybrid options (the CMM with REZ adaptations and the hybrid connection fee/CMM), both involving the CMM. The interim models do not address concerns raised with respect to the LMP/FTRs model. CMM rebate is not firm, which will impact contracting activity (including activity related to the Market Liquidity Obligation). CMM rebate does not provide generators with certainty which will impact how they participate in ESS markets and financial contracting arrangements. Before proceeding further, detailed analysis is required to ensure the implications of changes to transmission access on contracting arrangements can be fully understood. Implications for bilateral contracts currently on foot need to be considered – as participants will need to renegotiate contracts. It is important to understand whether disruption events (under ISDA agreements) will result from changes introduced by new arrangements, as this will impact the ability of counterparties to open existing contracts for renegotiation. Although less material, any changes will also have impacts on Exchange for Physical (EFP) contract liquidity and

		will affect participants using EFPs to manage credit risk.
45	Which medium term access option is preferable?	As noted, at present there is insufficient detail provided to allow participants to determine which option is preferable.
46	Are there alternative options that the ESB should consider?	The ESB needs to allow enough time to better understand the impacts of the other market design options being developed. Investment signals can be provided by other mechanisms.
47	Are there potential improvements to the options that the ESB should consider?	Insufficient information on the models has been provided.
49	What are stakeholder views on when these arrangements should be implemented by? What should be taken into account when determining implementation timeframes?	AFMA does not consider that there is a clear case to implement interim 'stepping-stone' reforms. If changes to transmission access are required, it makes sense to focus on finding a proper long-term solution that does not involve disruptive interim arrangements. While participants will benefit from increased certainty around implementation timeframes of new arrangements, any changes to transmission access arrangements need to be appropriately planned and coordinated to minimise the associated implementation costs for the market operator, participants, and end-users.