29 July 2022

Anna Collyer
Chair
Energy Security Board
Level 15
60 Castlereagh St
Sydney NSW 2000

By email: info@esb.org.au

Dear Ms Collyer

Capacity Mechanism High-Level Design Consultation Paper

The Australian Financial Markets Association (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, industry service providers and most relevantly here the energy companies which are key participants in the National Electricity Market (NEM).

AFMA appreciates that the NEM is in an unprecedented period of transition and that careful reform is required to ensure the reliable supply of electricity and a functioning market during the transition. AFMA's members have a range of views about the need for and design of a capacity mechanism, which they will articulate in their own submissions. Our submission focuses on the importance of minimising disruption to financial markets and has some observations on elements of the proposed design which may have an impact on the financial market.

1. Importance of the Financial Market

A well functioning financial market is essential to the success of the NEM as it allows participants to manage their risks and sends signals about the future direction of the market. The energy only design of the NEM has a number of positive attributes that our members are keen to preserve.

The key feature of an energy only market is that the spot price should represent the efficient price of electricity at any moment in time. The NEM spot price has been effective at sending short term operational signals to generators to ensure that electricity is supplied efficiently. Additionally, under the current design, the spot

price incorporates the key risks faced by participants, i.e. it is the price that generators must sell at and market customers must buy at. This means that the spot price is both a good basis for financial trading, as it incorporates the key risks faced by participants, and there are strong incentives for participants to contract to manage the risks inherent in the volatility of the spot price.

Capacity markets on the other hand have separate mechanism to provide signals for generation investment, our members are concerned that a poorly designed capacity mechanism could make the market less efficient by reducing the importance of the spot price. A poorly designed mechanism could increase costs as a result of over investment or make it more difficult for participants to manage their risks by moving their exposure from the spot price, which has a well understood financial market that can be used to manage risk, to a new capacity product that may be more difficult to hedge.

Any reforms should also aim to minimise disruption to existing contracts. AFMA understands that there are a significant number of existing bilateral contracts, including PPAs and OTC derivatives, with tenures that extend beyond any likely transition period. Ensuring that the spot price remains the key signal in the NEM would help to minimise disruption to these agreements.

2. Observations on the high-level design

AFMA is not advocating a preferred approach to the capacity mechanism but would like to make some observations about features of the proposed design that may have an impact on financial markets.

2.1. Encouraging participation in the NEM

We agree with the ESB that it is preferable capacity providers continue to be incentivised to participate in the energy only market for a substantial part of their revenue, rather than only running in response to defined 'at risk' periods under the mechanism. We support an approach where the capacity mechanism is designed to supplement the existing framework, rather than subsume it. That is strong scarcity price signals should be retained and capacity payments should be limited to providing greater certainty around a proportion of revenue to facilitate timely investment decisions. As a result, we think it is important not to lower the Market Price Cap so that the market can continue to send strong price signals.

2.2. Performance obligations of capacity providers

The design has proposed three possible approaches procuring capacity; centralised, decentralised and a hybrid approach. Under either a decentralised or hybrid approach market customers would purchase capacity products from capacity providers. If either of these approaches are adopted, it will be important to consider what happens when a capacity provider fails to deliver the contracted capacity so that both parties understand the risks of the transaction. For example, will market customers be liable for failures by capacity providers?

A clearly articulated position on this risk is likely to encourage the development of a robust market as purchasers of capacity will have confidence about the products they are buying.

2.3. Concurrent reforms

There are currently a number of concurrent processes considering reforms to the NEM. AFMA thinks it is important the impact of these reforms is considered as a whole to ensure that they are not in conflict. Particularly we note; the Reliability Panel's work doing on the market reliability settings (Market Price Cap, Administered Price Cap, Cumulative Price Threshold and Minimum Market Price) and the ESB's work on congestion management. We think it is important that reliability settings are set at a level that both

encourages efficient investment and operation while also considering the impact of any capacity mechanism. We also think it is important to consider the potential for the congestion management reforms to restrict the ability of capacity providers to deliver their services.

2.4. Jurisdictional opt-in

AFMA considers that ideally any capacity mechanism should be implemented consistently across the NEM. Due to the interconnected nature of the NEM we think capacity should be considered for the whole system as having the mechanism operate in only some regions would increase scheme complexity and reduce the effectiveness of the mechanism.

However, if jurisdictions wish to pursue alternative approaches, we think it is important to consider how the state and national schemes will interact with each other. The national framework could facilitate this by allowing a measure of divergence by states, for instance regarding the size of the targets or permitted technologies, while keeping them within the national framework.

Cost allocation

AFMA is keen to ensure that capacity costs do not become a new source of risk for participants in addition to the spot price. We therefore support a transparent approach to allocating capacity mechanisms costs to market participants that is predictable and provides market customers with incentives to reduce their exposure to those costs, including through demand response.

AFMA would welcome the opportunity to directly discuss the implications of the capacity reforms for the electricity financial market. Please contact Lindsay Gamble either on 02 9776 7994 or by email at lgamble@afma.com.au in regard to this letter.

Yours sincerely

Lindsay Gamble
Policy Director