AFMA

10 June 2022

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

By email: info@esb.org.au

Dear Ms Collyer

Transmission access reform

The Australian Financial Markets Association (AFMA) is providing an industry view on transmission access reform. AFMA members have extensively commented on the post-2025 review of the National Electricity Market (NEM). AFMA has been monitoring the Energy Security Board's (ESB) *Capacity Mechanism Project Initiation Paper* (Project Paper) consultation process and the results of the feedback seen in the *Transmission access reform Consultation paper* (Consultation 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, industry service providers and most relevantly here the energy companies which are key participants in the electricity market.

AFMA is commenting at the strategic level on the direction of reform travel as we believe that essential market threshold analysis has not been provided to give confidence that the design and current proposals take into account the financial market consequences of the design proposals. The focus on spot market access objectives without taking into account the essential financial risk management dimension supporting investment in energy distribution runs counter to the primary policy objective of the reforms which is to reduce cost to the consumer.

AFMA's focus is on the efficiency and competitiveness of electricity financial markets. Our key concern relates to the potential detrimental effects of the proposals on financial market liquidity.

After consideration of the Consultation Paper following on from the Project Paper AFMA's overall view continues to be that the access reform proposed by the ESB for the delivery of transmission access reform has not been justified at a basic level. The ESB has not provided the requisite policy analysis in accordance with the Australian Government's own *Guide to Regulation*. This requires the application of use of cost–benefit analysis (CBA) to assess regulatory proposals to encourage better decision making. A CBA involves a systematic evaluation of the impacts of a regulatory proposal, accounting for all the effects on the community and economy, not just the immediate or direct effects, financial effects or effects on one group. It emphasises, to the extent possible, valuing the gains and losses from a regulatory proposal in monetary terms. Consideration of the financial market impacts of the reform is a critical missing element.

The effectiveness of financial markets in providing risk management services depends on the extent to which they offer the products that market participants require. Adequate market liquidity is critical in this regard. In the electricity financial market liquidity relates to the ability of participants to transact a standard order within a reasonable timeframe to manage their load and price risk, using reliable quoted prices that are resilient to large orders, and with sufficient market participants and trading volumes to ensure low transaction costs. Electricity market participants seek certainty in their costs and revenues through hedging practices and contracting and active trading. Such activities involve quantifying, monitoring and controlling trading risks in the wholesale and retail power markets, which in turn requires appropriate risk management tools and methodology. On the supply side, managing risk associated with long-term investment in generation and transmission requires methods and tools for planning under uncertainty and for asset valuation. In turn, those who finance the necessary investment in the sector rely on the predictability provided by effective risk management to provide the level confidence that investment risk is within acceptable tolerances.

Open access to, efficient utilisation of, and adequate investment in transmission networks is critical for the electricity market to be workable and efficient. Since the value of electricity derivatives are based on the underlying electricity prices, modelling electricity price is the most critical component in pricing electricity derivatives. Due to the unique physical and operational characteristics of electricity production and transmission processes, electricity price exhibits different behaviours to other financial product pricing models, such as those associated with tangible commodities.

AFMA considers that Project Paper proposals have significant negative implications for forward contracting in the electricity financial market, and hence has the potential to hinder the efficiency and liquidity of this market.

In the Consultation Paper there is strong favouring for the introduction of locational marginal pricing (LMP) as part of the Congestion Management Model with universal rebates. AFMA was clear in its commentaries on the COGATI proposals that LMP was not viable from a market perspective. AFMA reflected its member views that the view that proposals had significant implications for forward contracting in electricity financial markets, and hence has the capacity to hinder the efficiency and liquidity in these markets. AFMA is concerned about the risk of developing and implementing a capacity mechanism that is overly complex and costly. The cost of any new capacity mechanism will ultimately be levied onto customers, and therefore will need to be finely designed so as to balance increased reliability with increasing costs.

ESB has chosen to make the introduction of LMP the centrepiece of its reform agenda. In our view any potential gains would be overwhelmed by the additional costs of LMP, in a number of ways, including:

- basis risk that cannot be hedged with consequent loss of contract liquidity;
- investment uncertainty, higher cost of capital and reduced investment;
- legal costs and uncertainty associated with reopening existing contracts; and
- increased cost of financial market contracts and ultimately electricity costs for consumers.

The basis risk implied by LMPs would significantly reduce contract liquidity. Contracting volume would be pushed to local nodes, fracturing traded volumes. LMPs would require many contracts across an increased number of nodes, favouring more active or resourced market participants. This would create barriers to investment and would hinder reduce competition.

In addition, the effect of power purchase agreements (PPAs) cannot be assessed as being benign. Generators would need to apply a risk premium to manage the increased risk exposure and the likely effect of this would be to reduce the level of contracting.

AFMA would welcome the opportunity to directly discuss our concerns about the need to have advertence to the effectiveness of the proposed transmission access reform in terms of the efficiency and liquidity implications for the electricity financial market. Please contact David Love either on 02 9776 7995 or by email at dlove@afma.com.au in regard to this letter.

Yours sincerely

David Love

David Love
General Counsel & International Adviser