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Dear Dr Schott,

RE: SACOSS Response to Market Making Requirements in the NEM

Thank you for the opportunity to provide a response to the Energy Security Board's (ESBs) consultation paper *Market Making Requirements in the NEM*.

As the peak body for the health and community services sector in South Australia, the South Australian Council of Social Service (SACOSS) has an established history of interest, engagement and provision of proposed advice on the necessary market mechanisms for and regulation of essential services. Our research shows that the cost of basic necessities like electricity impacts greatly and disproportionately on vulnerable people. Our advocacy is informed by our members and direct consultations with consumers and other consumer organisations: organisations and individuals who witness and experience these impacts in our community.

SACOSS has been an active participant in the ESB's Technical Working Group consultation process on the National Energy Guarantee design. Through this process we have reiterated our concerns around market concentration in South Australia and its effect on inhibiting an effective wholesale trading market. We have encouraged the ESB to consider how the reliability component of the guarantee can best be designed, and integrated with additional measures to ensure a workable and competitive wholesale electricity market in the State.

SACOSS endorses the ACCC's recommendation to implement a permanent market making requirement in South Australia as it aligns with the goals of the Market Liquidity Obligation (MLO) under the NEG reliability measure to promote liquidity, transparency, and competition in the NEM.

The only difference between the NEG and the ACCC's recommendation is that the reliability MLO would be implemented only when a reliability gap is identified, and only in the quarterly contract period where a reliability shortfall is forecast. The ACCC recommendation addresses the specific market deficiencies in South Australia with an enduring market making measure that will apply in all contract periods over a defined forward trading horizon. SACOSS favours a permanent market making measure that applies on a quarterly contract resolution for base swaps and caps over a rolling forward horizon of at least two-years (where trading interest is greatest).

SACOSS believes a permanent market making requirement is complementary to the MLO proposed under the reliability measure of the NEG. Both measures can work together in South Australia and could in fact be condensed into one measure for efficiency purposes. The identification of a reliability gap in South Australia and triggering of the reliability obligation in the T-3 period could be

applied to the relevant quarter as required. Any shorter-term triggering in T-2 or T-1 quarterly periods would already be covered by the permanent market making measure.

Whilst the proposition to have large vertically integrated utilities operate their retail and wholesale businesses at arms-length has been considered premature by the ACCC, SACOSS believes an on-again off-again market making mechanism would be undesirable in promoting and achieving a consistent increase in market liquidity. The permanent market making measure in South Australia should be implemented for at least two years before a review of its effectiveness is undertaken, and before a liquidity test is applied to assess market liquidity in the region and determine its continued operation.

The requirement for arm-length trading should be seriously considered as an alternative measure to improve competition and achieve lasting structural change in South Australia should the permanent MLO be proven to be ineffective in promoting trading liquidity and improving competition, if it is repeatedly triggered and cancelled, or if there is no improvement in reducing the concentration of generation ownership in a region.

The remainder of this submission is set out to respond specifically with the questions raised in the consultation paper.

We thank you in advance for consideration of our submission. If you have any questions relating to the above, please contact SACOSS Senior Policy Officer, Jo De Silva on (08) 8305 4211 or via jo@sacoss.org.au.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Jo De Silva', written over a light grey rectangular background.

Ross Womersley, Chief Executive Officer

Section 2 – Triggering the Market Liquidity Obligation

The introduction of the market making arrangement in South Australia as proposed under the ACCC's Recommendation 7¹ could be implemented in a relatively short space of time. The large vertically integrated entities that would be required to provide the market making bids and offers are all sophisticated market participants with established trading systems and resources. A maximum of three-month's notice should be sufficient for them to establish the necessary policies and procedures to administer the MLO requirements.

The products offered by obligated parties under the MLO should cover base and peak swaps, and cap contracts. Bids and offers for each contract type should be posted on quarterly contracts on a two-years forward rolling basis. Quarterly resolution will allow flexibility for smaller market participants to manage specific portfolio requirements, while a two-years forward MLO horizon will enable purchasing of a strip of quarterly contracts to cover annual hedging requirements for the coming two years.

SACOSS supports the use of a benchmark ratio of the total exchange and OTC contract trades against the energy demand in a region in determining the liquidity test. Trading activity in Q1 contracts in South Australia (and other NEM regions) is generally greater than other quarterly periods, so a liquidity benchmark would need to ensure that the test is reflective of trading activity occurring across all quarters in a calendar year to ensure a representative estimate of regional liquidity is determined.

As discussed earlier in this submission, SACOSS believes the reliability and liquidity market making arrangements can operate in unison across all NEM regions. The benchmarks and methodologies for determining obligated participants, establishing liquidity test parameters, and undertaking scheme review and monitoring can be made consistent for both NEG and ACCC requirements. In South Australia, where the permanent market making obligation is implemented to improve market competition, a two-years forward rolling obligation to provide quarterly contract bids and offers would cover the T-2, and T-1 reliability trigger requirements under the NEG. A T-3 reliability trigger and MLO could be selectively applied to a particular quarter (in the third year forward) where the reliability gap is forecast. The MLO would roll automatically into the permanent market making measure once the T-2 interval is reached.

The circumstances that would initiate a review of the MLO could include:

- Repeated cycles of passing and failure of the MLO liquidity test leading to the MLO coming in and out of operation (following the two-year period of initial operation);
- No improvement in the liquidity in wholesale contract market trading in regions where an MLO is implemented;
- No improvement (or worsening) in the concentration of generation ownership; and
- Significant market structural changes (including asset ownership, and participant business aggregation/disaggregation).

Section 3 – Identifying Obligated Parties

In selecting obligated participants under the MLO, SACOSS favours an approach that reduces market concentration in both the retail and generation segments to improve market competition. Selecting

¹ ACCC Retail Electricity Pricing Inquiry – Final Report, June 2018

the three largest participants in a region would be a workable arrangement in determining obligated parties, and would capture all relevant large, vertically integrated retailers.

Determining the generating capacity of a participant should be based on their level of registered, scheduled capacity they own or control (i.e. under tolling arrangements). An exemption could be allowed for generators whose capacity is fully contracted with an end use customer under a long-term contractual arrangement as this capacity would not be available to contract in the market.

Historical availability may not be a representative estimate of a generator's market position, particularly if their portfolio includes a large amount of gas-fired peaking plant that would generally operate at a low capacity factor, as they would still be able to sell cap contracts into the market. If an historical availability measure is applied, then only measurable incidences of lower availability linked to unit planned outages should be included. Strategic shutdowns or temporary mothballing of capacity, as occurred in South Australia in 2015 when Engie removed one Pelican Point unit from service for an extended period for commercial reasons should not be incorporated in the availability measure.

Semi-scheduled and non-scheduled generation should not be included in the assessment for determining an obligated party as these forms of generating capacity do not conform to the NEG definition for dispatchable energy, which is relevant in determining contractual compliance with the reliability guarantee in the event that a reliability obligation is triggered. The "non-firm" nature of intermittent generating capacity limits the ability to utilise these assets to back firm market contracts.

SACOSS does not support the requirement for obligated parties to have a retail business over a specified size (i.e. in terms of either load or total customer numbers). The concentration of generation ownership in South Australia is just as influential in limiting the liquidity in contract trading and inhibiting competition as the existence of vertically integrated retailers. Three participants; AGL, Engie, and Origin Energy own more than 85% of scheduled generating capacity in the region². Incentivising the development of additional generating capacity from new or smaller market participants is important in reducing the level of generation ownership concentration, removing barriers to entry, and improving market outcomes in the region.

Section 4 – Market Making Requirements

Though a centrally cleared platform for applying the MLO is preferred by the ESB, SACOSS notes that this may not be appropriate in the case of South Australia. The charts in Figure 5.3 of the consultation paper demonstrate that unlike other NEM regions, quarterly OTC trading volume in South Australia is comparable with, and often exceeds ASX Energy futures trading levels. In other NEM regions, ASX Energy futures trading is generally the dominant platform.

Many small retailers do not have the financial resources to manage initial and variation margin requirements that centrally cleared platforms such as ASX Energy futures entail, pushing them to OTC markets. The cost of credit support and financial guarantees required of smaller, less credit worthy participants in OTC markets can also be an inhibitor in them being able to purchase contract volume.

The inability to trade in either centrally cleared or OTC markets can be a significant barrier to entry for new entrants, though SACOSS acknowledges that the MLO is not designed to specifically deal

² AER, State of the Energy Market, May 2017

with this issue. We do propose however that the ESB give further consideration to the MLO being applied to both centrally cleared and OTC platforms to allow a wider range of market participants to trade and encourage the development of non-standard and flexible contracting products.

The volumes associated with bids and offers posted under the MLO (whether on centrally cleared or OTC platforms) should consider the requirement for smaller parcel sizes often purchased by smaller market participants. SACOSS supports the principle that bid and offer parcel sizes be at least 5MW, with minimum trades of 1MW allowed (as is currently available under ASX Energy futures).

SACOSS believes that the maximum bid-offer spread applicable under the MLO should be set as tight as reasonably possible. The ESB's suggested maximum spread of 5% is in SACOSS's opinion too wide to provide reasonable guidance on swap prices in the T-1 period but is appropriate for T-1 period cap contract premiums (due to cap contract premiums being priced at lower levels to swap contracts). SACOSS proposes a sliding scale of maximum bid-offer spreads with a maximum of 3% on swap contracts and 5% on cap contracts in the T-1 period, 5% on swap and cap contracts in the T-2 period, and 10% on swap and cap contracts in the T-3 period to reflect the higher market uncertainty and price risk in the latter years. The proposed maximum swap spreads in T-1 and T-2 are in alignment with the spread ranges analysed by the ESB and discussed in the consultation paper and strike a balance between providing accurate market price indications and allowing obligated parties enough leeway to manage positions and market fluctuations.

The proposal to operate the MLO at a consistent time during a trading day is supported by SACOSS, however, rather than operate for the last 30 minutes of a trading day, SACOSS proposes to increase this to one hour to enable an orderly posting of bids and offers and considered response by market participants.

The timeframe for obliged participants to refresh bids and offers should a contract trade should be guided by the maximum volume limit that a participant is required to sell over a period, which in turn is determined by their level of generating capacity. In a region such as South Australia, where scheduled demand is modest relative to other NEM regions, the maximum volume limit assigned to obligated participants may be quite low. If the MLO was to apply over the last hour of trade then it would be reasonable to expect obligated participants to refresh their offer price in the event of a trade within 15 minutes, limiting the number of potential trades per obligated participant on any given trading day to four (assuming their daily, weekly, or monthly assigned volume limit is not reached).

In relation to safeguards, the forecast inputs into the Electricity Statement of Opportunities (ESOO) could be used to adjust the generation market shares of obligated participants on an annual basis (or more frequently in the case of the reliability obligation if AEMO was to update supply/demand projections). This would incorporate changes to participant registered scheduled generating capacity, including the addition of new capacity, permanent adjustments to the registered capacity of existing plant, and the closure of generating capacity. Under the reliability obligation, such changes could influence the actual triggering of the reliability gap, the requirement for the reliability MLO, and the respective trading limits of obligated participants.

For the permanent market making arrangement in South Australia, the generating capacity adjustments would only result in changes to the level of traded volume of obligated participants or shift in responsibility between participants. As registered scheduled generation changes do not occur at short notice and are generally well announced, SACOSS does not believe adjustments to the permanent market making obligation need to be implemented any more frequently than annually.

Section 5 – Satisfying the Obligations

SACOSS supports the ability for obligated participants to utilise alternate, formalised market making measures to satisfy the reliability or permanent market making obligations, so long as they are approved (and auditable) by the AER and do not unduly increase the complexity or cost of participation for other market participants.