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via the AEMC website

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Submission to Market Making Arrangements in the NEM – ERC0249

AGL Energy (**AGL**) welcomes the opportunity to comment on the Australian Energy Market Commission's (**AEMC**) Market Making Arrangements in the NEM consultation paper (**Consultation Paper**).

AGL is one of Australia's leading integrated energy companies and the largest ASX listed owner, operator and developer of renewable generation. Our diverse power generation portfolio includes base, peaking and intermediate generation plants, spread across traditional thermal generation as well as renewable sources. AGL is also a significant retailer of energy and provides energy solutions to over 3.5 million customers in New South Wales, Victoria, Queensland, Western Australia and South Australia.

In considering whether a market making arrangement is required in the National Electricity Market (NEM), AGL notes the importance of defining the problem to be solved. The best results will be achieved by addressing the cause of the issue, and not one of the symptoms. AGL believes the fundamental issue driving discussions around the introduction of a market making requirement is the higher wholesale prices seen in recent years.

The key drivers of higher prices in the wholesale market are not related to liquidity per se, but the tightening of supply and demand. The withdrawal of thermal generation from the market and the increasing unreliability of aging thermal generation have impacted both wholesale prices and contract liquidity. Participants are not withholding forward contracts, but there are currently fewer generators that are capable of providing firm contracting than there have been in the past.

The trading of electricity forward hedge contracts occurs through the Australian Stock Exchange (ASX) futures market, over the counter (OTC) markets or transactions negotiated directly between two counterparties. The amount of trading volume and overall liquidity in derivative markets is reflective of and affected by any number of factors with varying degrees of influence, for example the changing size, nature and dynamics of the underlying market.

Most importantly, liquidity in derivative markets can be adversely affected by increased risks arising from regulatory change and policy uncertainty, the likes of which we have seen consistently in the energy market over the last decade and which have been well documented. The uncertain regulatory and unstable policy environment has created a set of conditions that most likely have had and will continue to have an adverse impact on investment in new generation, liquidity, and confidence in the forward markets for electricity, thereby potentially limiting the most efficient price outcomes for consumers.

Trading volume and overall liquidity in markets have also likely been adversely affected by increases in credit obligations imposed on participants by trading exchanges and market operators, which ultimately arise from these increased policy and regulatory risks.

Despite the likely impact of regulatory and investment uncertainty on the contract market over the last few years, we note that the argument of declining liquidity is not necessarily supported by evidence. In the latest publicly available Australian Financial Markets Association (AFMA) electricity survey released for financial year 16-17, the report concluded that overall contracting turnover had remained relatively consistent over the previous three financial years of the report (see https://afma.com.au/data).

AGL is supportive of and is an active participant in all the markets in which it operates, in order to promote price transparency, contract liquidity, competition, confidence, and ultimately, more efficient operation of these markets. For example, AGL supports the development of the Victorian gas futures markets so that there is increased price transparency for all stakeholders in the gas markets.

Derivative markets by their nature reflect the market's view of underlying market conditions into the future, in this case and more specifically, the forward market for electricity reflects the market's view of potential future spot price outcomes. AGL notes that any proposal to introduce a formal market making arrangement in the contract market will not address the well documented issues in the underlying market (such as investment in new firm generation capacity). Requiring liquidity for the sake of liquidity will not assist with the higher wholesale electricity spot prices that have evolved in recent years.

As an active supporter of, and participant in, derivative markets, AGL is currently one of a number of parties in discussions with the ASX to participate in its proposed voluntary market making scheme. Depending on the outcomes of these discussions, the ASX may or may not enter into commercial agreements with a number of participants, including AGL, to provide bid and offer prices on a voluntary basis and under agreed terms and conditions.

With respect to the costs and benefits of the different forms of a formal market maker arrangement set out in the Consultation Paper, AGL makes the following comments.

Mandatory market making requirements

AGL has significant concerns with the view put forward that increased liquidity should be driven through the imposition of a mandatory market making requirement. Forcing market participants to make a tight bid and offer spreads will likely have costly unintended consequences. These participants will need to manage the increased market risk which is likely to arise from meeting this requirement.

AGL agrees with the rule proponent's characterisation of the issues with a mandatory market making scheme. In particular:

- Obligations on unwilling participants are likely to result in a higher-cost scheme. While they may provide bids and offers as required, they will likely need to address associated risks through additional hedging, or at worst these risks could be unmanageable. For example, generators that rely on a fuel source may be forced to participate in futures markets where they cannot always guarantee that they will be able to access fuel or generate to meet those contracts. If a mandatory requirement is introduced, this interaction would need to be considered further. On the other hand, willing participants may be able to provide bids and offers at a lower cost.
- Mandatory market making may in fact limit the participation of financial market participants without physical generation assets due to the removal of incentives for them to make the markets.

Given the unnecessary risks that would be placed on those companies forced to participate combined with the fact that the ASX is currently consulting with market participants on the proposed implementation of a voluntary scheme, AGL does not consider it necessary or prudent to introduce a mandatory market making arrangement.

Voluntary or incentivised market making arrangements

The existing discussions with the ASX on potential market making arrangements are being conducted on a voluntary basis. Market participants may be encouraged to participate to take advantage of the potential exchange fee discounts that will apply. There are no penalties involved should a participant not comply with their market making agreement (apart from becoming ineligible for their exchange fee discounts).

An appropriately incentivised scheme (as suggested by the rule proponent) provides greater financial incentives to participate, which would have the following outcomes:

- Incentivised schemes can impose a stronger compliance regime. Market makers must continue to provide bids and offers during times of market stress (which can result in those participants trading at a loss) but this is offset by the greater incentives provided to participate.
- It may encourage financial intermediaries to be market makers, who are likely to need a greater incentive to participate than simply a reduction in exchange fees. We note that the participation of financial intermediaries may help market participants who wish to transfer price risk and may also offer other non-trading services (such as re-allocation).

However, given the ASX is already working on the potential introduction of a voluntary market making scheme, AGL believes that any decision to introduce an additional scheme to promote liquidity needs to be underpinned by an objective assessment of the problem it purports to solve, including an assessment of the existence of the issue, its cause, and an analysis of potential costs and benefits associated with introduction of a formal market making arrangement.

AGL believes it would be more effective to address the policy risks and regulatory uncertainties that continue to affect the underlying energy markets. Policy certainty will help contribute to an increase in generation capacity that is capable of supporting firm contracts and may exert a downward pressure on price.

Other comments on the Consultation Paper

If it is deemed necessary that an incentivised market making arrangement is to be introduced in the future, we request that the AEMC carefully consider the appropriate body to regulate and manage the scheme. To provide funding for incentives, it would need to be managed through an appropriate market regulator that has relevant experience with regulating financial contracts.

The design and operation of the tender process could be outsourced to an appropriately qualified body (such as the ASX). This would also help to minimise administrative costs as some participants have already developed systems to integrate with the ASX, which would enable the effective monitoring of compliance with the market making scheme. If a separate process is implemented, it may result in an inefficient use of resources and duplication of requirements and operations.

Conclusion

Given the potential introduction of a voluntary market making scheme by the ASX, AGL considers it may be prudent to delay further consideration of the rule proposal until it is clear whether the ASX reaches agreement with market participants and if the scheme becomes operational, that it is successful in promoting overall market liquidity. Any decision to proceed with an incentivised scheme should be subject to a robust assessment of the costs involved and the incremental benefits that the market maker requirement would provide.

If it becomes clear during 2019 that the ASX voluntary scheme does not proceed or is unsuccessful in meeting its aims, and an incentivised scheme is deemed more appropriate, the AEMC would be able to build on the Australian specific experience gained through the ASX proposal to design and implement an incentivised scheme.

If you have any queries about this submission, please contact Jenessa Rabone on (02) 9921 2323 or JRabone@agl.com.au.

Yours sincerely,

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