AFMA

13 July 2018

Dr Kerry Schott AO
Energy Security Board
By email: info@esb.org.au

Dear Dr Schott

ESB National Energy Guarantee – Draft Detailed Design Consultation Paper

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comment to the Energy Security Board (ESB) on the National Energy Guarantee (the Guarantee) Draft Detailed Design 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, energy companies and industry service providers.

As the national association for participants in the wholesale financial markets, AFMA has established trading protocols and developed standard contract documentation, as well as providing market information, dealer accreditation, training and other services to facilitate the efficient operation and development of the electricity financial markets.

Whilst acknowledging the overall objectives of the consultation paper, AFMA's focus is on the efficiency and competitiveness of electricity financial markets. Accordingly, our comments are limited to those areas that relate to this focus.

Efficiency and competitiveness of electricity financial markets

We note in the Executive Summary that the Guarantee has been specifically designed to ensure it "does not undermine but rather enhances the liquidity, transparency and the level of competition in the retail and wholesale electricity markets." AFMA agrees that this needs to be a key objective of the design and appreciates the efforts that the ESB has made in recent months to engage with stakeholders to ensure that this is the case. We note in particular the following developments:

- The emissions registry approach for compliance with the emissions reduction requirement of the Guarantee, rather than the physical linking of contracts to their emissions source, as suggested in the previous consultation earlier this year.
- The flexible, high-level framework approach to the definition of qualifying contracts for compliance with the reliability requirement of the Guarantee, rather than previous suggestions of physically-backed financial contracts in the previous consultation.

AFMA welcomes further opportunities to continue this dialogue to further refine and finalise the design to achieve this important objective.

The emissions reduction requirement

We note in the Executive Summary that the emissions registry recommended in the paper allows for market customers to be allocated a share of a generator's output and its associated emissions, and this can be based on any contractual arrangement held with a counterparty outside the emissions registry, as long as both parties verify the agreement in the registry. This approach provides for a high level of flexibility in meeting the emissions reduction requirement, which AFMA supports.

It is reasonable to expect that the market should be able to develop an efficient market-based solution for emissions allocation transactions. AFMA, through its market committees, has a long track record in establishing trading protocols and developing standard contract documentation for a number of contractual arrangements in the energy sector, and is therefore well placed to support the development of contractual arrangements for emissions allocations in a similar manner.

The Energy Security Board needs to continue to be mindful of the likely development of a contract market in emissions allocations. Continued flexibility in the design of the registry and adaptability in the AEMC rule making process will be necessary so as not to unintentionally impede the development of a market that allows for emissions allocations. This means that the legislative framework should allow for reasonable degree of administrative discretion with regard to rule making. There are a number of useful examples of such frameworks to be drawn from the powers granted to the Australian Securities and Investments Commission (ASIC) under the *Corporations Act* in relation to aspects of financial service supervision. AFMA would be happy to assist in the identification of such models.

With respect to the detail of the emissions registry as contained in the technical working paper, AFMA members' views are mixed on various aspects (such as on who the registry administrator should be and third party access to the registry), and we expect that individual AFMA members will address their concerns in their own submissions.

The reliability requirement

We note in the Executive Summary that the reliability requirement builds on existing spot and financial market arrangements to facilitate investment in dispatchable capacity. As noted above, AFMA supports the high-level framework approach to the definition of qualifying contracts, rather than a prescriptive approach which would likely have had a larger risk of impeding financial market effectiveness.

Having said that, some of our members have expressed concerns with respect to the measures that will be put in place to ensure that the reliability obligation does not adversely impact on liquidity, transparency and competition, such as the trade reporting approach to support transparency of the market and the Market Liquidity Obligation.

In discussions that AFMA has had with its members, we note that views are mixed with respect to the necessity of a trade repository, the form and content of trade repository, and its transparency. In general, a light-touch trade repository solution is preferred by our members, if a trade repository approach is required at all. Issues raised by some members include the following:

- If the Market Liquidity Obligation or a similar liquidity provision arrangement is in place, and separate arrangements are in place to allow for internal transfers of vertically integrated entities to be qualifying, then it is arguable as to whether a trade repository is necessary.
- If a trade repository is considered necessary, then it would be important to ensure that the form and content of a trade repository is fit for the compliance purpose, and not be overly burdensome and costly to industry (as noted in the consultation). Alternatives to trade repositories could be established to provide the requisite transparency without undue burden on industry such as a market survey mechanism.
- There are concerns about the benefits of utilising a trade repository to enhance transparency, whilst revealing commercially sensitive information about energy participants.

It should not be automatically assumed that transparency is necessarily a positive for the development of nascent markets which are illiquid or transact periodically in large single transactions amongst a small number of participants. The academic analysis supports the value of transparency in markets that have achieved significant transactional scale and have many participants. This illustrates the importance of adaptability of the legislative framework and market rules so as to allow for encouragement and evolution of a market mechanism.

The Market Liquidity Obligation is a new market making mechanism suggested by the ESB in this consultation, and was not contemplated in previous consultations. We understand that it would be established to ensure that liable large customers have access to contracts to cover a forecast reliability gap. Member views have also been mixed with respect to this suggestion, and in general, members expressed a desire for a flexible approach toward determining a solution. Issues raised have included the following:

- The size threshold for each region means that only a small number of participants would be required to make markets under the obligation. We expect that those participants liable to make markets will raise their own concerns in separate individual submissions.
- A number of members expressed a preference for a market liquidity mechanism that does not involve compulsion, noting a mechanism that provides incentives for market making would be preferred. A market participant-lead solution to provide liquidity might be considered, with a compulsory liquidity obligation as a fallback process.
- Some members expressed concern that the market makers may end up with unwanted and excessive financial risk as a result of their market making activities.
- There are a number of alternative mechanisms that can provide liquidity in line with the requirement, and these should be explored more fully.

AFMA is keen to ensure that the electricity forward contract markets will continue to work efficiently and effectively under the National Energy Guarantee. We urge the ESB to continue to take a flexible approach to achieving the objectives of the Guarantee, and look forward to working further with the Energy Security Board to achieve these objectives.

Yours sincerely

Mike Chadwick
Head of Education and Director - Markets
mchadwick@afma.com.au