



8 March 2018

Dr Kerry Schott AO
Energy Security Board

By email: info@esb.org.au

Dear Dr Schott,

ESB National Energy Guarantee – Draft 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 (NEG) Draft 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 data services, 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.

Efficient and liquid contract markets

We note in the Executive Summary of the consultation paper that “increased contracting in deeper and more liquid contract markets is expected to reduce the volatility and high prices we've seen in our wholesale National Electricity Market over the last year further improving the affordability of electricity.” AFMA agrees that

deeper, transparent and more liquid contract markets can have the benefit of reducing volatility and high prices, among many other things. An efficient, liquid financial market in electricity derivatives, which is a key objective of AFMA, has a number of additional benefits, some of which are illustrated in Appendix C of the consultation paper, such as:

- Enabling participants to effectively convert uncertain future spot market prices into more certain wholesale prices to better match upstream or downstream obligations that are relatively stable across time;
- Lower participants risk profiles and enable them to obtain equity and debt financing from suppliers of capital;
- Mitigating revenue risk for generators and expense risk for retailers, as well as underwriting contracts offered to retail customers; and
- Supporting investing decisions.

In the design phase of the NEG, the ESB needs to be particularly mindful of ensuring that any design does not unintentionally limit the ability of electricity derivative markets (both futures and over the counter) to function efficiently and effectively. AFMA is keen to work with the ESB to ensure that this is the case.

The emissions requirement

AFMA notes the design options suggested with respect to contracts in Section 3.3 regarding the emissions requirement. To the extent that the high-level design options do not impede efficient financial market functionality, AFMA is supportive of achieving this objective with market-based solutions.

Section 3.3 of the consultation paper suggests a “contract that specifies the emissions per MWh but do not specify a generation source” noting that such contracts do not yet exist. AFMA believes that this suggestion may be problematic, as it may detract from liquidity in the current market. This type of contract could introduce a bespoke condition (emission) into the contract, and would mean that the product would be non-homogenous and illiquid. It could also be detrimental to the overall liquidity and depth of the electricity financial markets, to the extent that it may take away liquidity from the standard contract markets, both exchange traded and over the counter. In addition, depending on design, there may be difficulties in determining an appropriate reference rate for valuation and settlement, and difficulties in contractual arrangements under standard ISDA (International Swaps and Derivatives Association) documentation.

Section 3.3 also suggests that contracts could take the form of a “stapled security” where a specified amount of emissions per MWh is “stapled” to those types of contracts currently in existence. We are not sure how this would work in practice, but would be keen to explore such a solution provided that it did not detract from the current efficiency of the markets as they currently exist.

The reliability requirement

It is unclear, but the consultation paper appears to suggest that the electricity derivative financial market should move to a more physical-backed version, rather than a primarily

financial one. AFMA believes that any shift in contracting markets from financial to physically-backed would be detrimental to financial market efficiency, liquidity and price transparency, as contracts would be less homogenous, and priced on a case-by-case basis. However, we are presuming that this is not the intent of the ESB.

The consultation paper also suggests that financial contracts could be “certified” (ie; uniquely identified with a particular physical generator). As noted in the consultation paper, this could have the impact of limiting liquidity in the financial markets which would be counter to the objectives of the Guarantee. AFMA agrees that this is also likely to reduce liquidity.

AFMA’s work in developing solutions.

As most of the current electricity forward contracts are in the form of electricity derivatives, AFMA is the industry group that represents the companies that transact in such contracts, and consequently we are keen to be significantly involved in the design process. This would assist in ensuring that the electricity forward contract markets continue to work efficiently and effectively. We are keen to continue to engage with the Energy Security Board and relevant regulatory and other bodies (such as AEMO, AER and AEMC), so that we can offer our expertise to assist in further design work.

AFMA members have had preliminary discussions about financial market solutions that may achieve the objectives of the emissions and reliability requirements, whilst not detrimentally affecting financial market efficiency and liquidity.

For example, to meet the Reliability objective, some form of separate “reliability” product could be developed so that market participants could manage their obligations under the Reliability objective, whilst not affecting their ability to hedge efficiently in the current electricity financial markets. AFMA could be instrumental in developing standard terms and conditions for a tradeable derivative market in a homogenised reliability product which allows participants to manage their risks and maintain compliance with the Reliability objective as it is developed. Similarly, some form of product may also be developed which helps to satisfy the emissions requirements, whilst continuing to allow the electricity financial markets to function effectively.

Yours sincerely

A handwritten signature in black ink, appearing to read 'M. Chadwick', written in a cursive style.

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