AEMC

INFORMATION

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Market making arrangements in the NEM

The AEMC has decided not to make a rule introducing additional market making schemes in the national electricity market

A number of initiatives are already under way that should increase contract market liquidity, in particular the ASX's voluntary market making scheme, which commenced on 1 July 2019, and the market liquidity obligation (MLO) which is part of the Retailer Reliability Obligation (RRO), which also commenced on 1 July 2019. The Commission's analysis found that additional market making arrangements beyond these initiatives are not justified at present.

At the same time, the Commission has proposed a range of initiatives to improve transparency in the electricity contract market. This would improve price discovery for those seeking to buy and sell hedge contracts, and also make it easier for regulators to assess market performance including liquidity.

Final determination

The Commission's analysis has found that additional market making arrangements beyond the ASX and MLO initiatives are not likely to be efficient. On this basis, a rule to require additional market making services would not likely contribute to the National Electricity Objective.

Key findings include:

- Liquidity across the NEM is generally healthy, although liquidity in South Australia is much lower than in other regions.
- The structural characteristics of the South Australian market contribute to lower liquidity. The characteristics include limited firm generating capacity, a heavy reliance on gas for firming capacity, high penetration of renewables, low levels of demand, limited interconnection and high levels of vertical and horizontal integration which can reduce the broader availability of contracts.
- The ASX and RRO/MLO schemes are expected to improve liquidity compared to the levels currently observable in the market. These improvements should be most notable in South Australia.
- The Commission engaged a consultant, NERA Economic Consulting, to undertake an in depth analysis of the costs and benefits of the different types of market making arrangements put forward. The results of that analysis were released along with the draft determination. The analysis concluded that if the ASX scheme delivers to its design, then there would be no additional benefit from additional market making schemes. There would however be additional costs.

In the first two months operation of the ASX scheme since 1 July 2019, there has been a noticeable improvement in the coverage of prices in market making products, particularly in South Australia. While the number of participants signed up to the scheme has fallen short of the levels anticipated, with only three in total, there are two market makers in South Australia. Given liquidity is lower in South Australia compared to other jurisdictions, the presence of two market makers in the region, as anticipated in the analysis and modelling for the rule change request, is encouraging for the ongoing success of the scheme.

In relation to broader liquidity metrics which the Commission has considered as part of the rule change request (including measures such as contract turnover, trading versus non trading days, the number of trades on each day, bid ask spreads), there are some positive signs in relation to turnover but otherwise it is still too early to observe changes in broader measures of liquidity. The Commission notes that the scheme has only been in operation a short while and more time is needed to allow for wider participation and the observation of key performance and liquidity metrics as scheme and market participants alike adjust to the requirements and opportunities presented by the scheme.

The final determination also sets out specific monitoring and reporting that the Commission considers should be undertaken by the Australian Energy Regulator. This includes monitoring participation in, and operation of, the ASX voluntary scheme and implementation of the MLO/Retailer Reliability Obligation to see if these new market making arrangements provide the intended benefits to contract market liquidity. This function would be enabled by proposed law changes to expand the AER's market monitoring function to include the contract market.

The final determination identifies improvements that are needed in relation to the reporting of OTC trades through the AFMA survey, including the key dimensions of pricing data, coverage and timeliness. Decisions in regards to these improvements should be made before the end of 2019.

In the event that an enhanced survey is unable to provide the improvements in information that the Commission has identified, the Commission will concurrently work with the AER on alternative approaches to address information gaps in the OTC market.

The Commission will also work with the AER to determine whether large vertically integrated market participants should regularly report specific additional data to enable ongoing assessment of market conduct and performance.

Background

Market making arrangements aim to increase opportunities for market participants to trade in electricity hedge contracts and to have greater visibility of wholesale contract prices. They can be voluntary or compulsory.

The service is typically made available in less liquid markets so that retailers and other market participants always have an opportunity to buy and sell electricity futures contracts. This helps to increase market liquidity and support competition and confidence in the market as a whole.

There has been significant work undertaken in relation to market making, both by policymakers and by the ASX:

- A market liquidity obligation (MLO) forms part of the Retailer Reliability Obligation which commenced on 1 July 2019. South Australia has additional specific arrangements that allow the MLO to be triggered in that state potentially earlier and more regularly than in other jurisdictions.
- The ACCC recommended that the AEMC introduce a market making obligation in South Australia to boost market liquidity as part of the Retail Electricity Pricing Inquiry published in July 2018.
- The ESB released a consultation paper on the need for a market liquidity obligation in South Australia in September 2018. It has deferred further work on this assessment until after this rule change process is complete.
- In November 2018 the Commonwealth government put forward the Prohibiting Energy Market Misconduct Bill which included (i) a prohibition on generators from withholding electricity contracts with the aim of substantially lessening competition in the market, and (ii) a power for the Treasurer to direct participants to market make. While the Bill was withdrawn prior to the federal election, the government has subsequently indicated it will re-introduce the Bill.
- The ASX commenced a market making scheme in South Australia, Victoria, New South Wales and Queensland on 1 July 2019.

Internationally, market making arrangements for electricity markets have been introduced in recent years in New Zealand, Singapore and the United Kingdom, and considered but not introduced in Ireland.

The rule change request

ENGIE submitted a rule change proposal in October 2018 proposing a tender for voluntary market making services in all states in the NEM, to be run by the Australian Energy Regulator. The proposal was put forward as an alternative to a compulsory market making obligation. The request asked that consideration be given to complementing the ASX market making scheme under development and called on the AEMC to examine in more detail questions about the level of contract market activity across the NEM and in South Australia in particular.

On 20 December 2018 the Commission published a consultation paper on the rule change request.

On 28 February 2019 the Commission held a workshop in Melbourne to gather industry views on the operation of the contract market and to gather feedback on the different market making arrangements that could be applied to help encourage greater liquidity in the contract market.

On 27 June 2019 the Commission published a draft determination. At the same time as the draft determination, the Commission also published a report commissioned from NERA Economic Consulting on the Costs and Benefits of Additional Market Making in the NEM.

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