INFORMATION

Short Term Forward Market final determination

Summary

The Australian Energy Market Commission (AEMC) has made a final rule determination and decided not to make a rule to introduce a voluntary market for short term financial electricity derivatives in the NEM, as it considers it is unlikely this would contribute to the National Electricity Objective.

Context and rule change request

In the AEMC's 2018 Reliability Frameworks Review on possible improvements to reliability in the NEM, the Commission identified that a short term forward market might be beneficial to increasing demand response in the NEM. Subsequently, on 20 December 2018 the AEMC received a rule change request from the Australian Energy Market Operator (AEMO) to amend the National Electricity Rules and introduce an exchange for short term forward contracts.

The rule change proposed a short term forward market (STFM) for electricity derivatives that would operate alongside the NEM and the existing financial contracts market. It would use a model similar to that of the AEMO-operated Gas Supply Hubs (GSH) including using the same platform (Trayport), and processes for clearing, settlement and prudential arrangements. Some specific characteristics of the market included:

- voluntary and anonymous trading
- exchange trading of standardised short term electricity derivative contracts
- contracts traded daily on a rolling basis for the following day and up to seven days in advance
- transaction prices and quantities published on the AEMO website.

AEMO suggested the STFM, if liquid, could:

- contribute to the reliable and secure supply of electricity by addressing potential barriers to demand-side participation, and creditworthiness and collateral requirements for smaller participants—providing more avenues for participation could lead to more efficient spot market outcomes and long term investments
- improve short term operational decisions of market participants in the face of volatile market conditions, e.g. holding a swap contract incentivises generators to be available when needed to earn revenue in the spot market to fund payouts on their contract positions
- support long term contracting by signalling market expectations of future spot prices, lowering the cost of financing investment in generation capacity and underwriting retailers' fixed price offers to end-customers.

Final determination

If the benefits from the STFM for financial derivatives were to be realised by participants, the voluntary STFM would need to be liquid and traded on.

To understand the way that participants currently manage their risk and determine the underlying level of demand for short term hedge contracts, the Commission consulted widely, meeting with small renewable participants and new entrants, established vertically integrated participants, brokers, exchanges, and industry bodies.

The rule change proposal identified three groups of participants that may benefit from short term hedging, namely intermittent generators, demand response participants and gas peaking generators.

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- Discussions with intermittent renewable generators revealed that there was mixed demand for short term financial firming products. Two larger participants stated that short term hedging products may be useful for optimising within their diversified generation portfolio. However, most other participants stated they preferred to manage their price risk on a longer term basis. Other products such as power purchase agreements, proxy revenue swaps and longer term solar and wind firming products were more attractive as they further reduce investors' exposure to risk and do not require an active trading desk.
- Demand response participants also showed little interest in short term financial hedging products. Participants noted that the likely clearing price of a short term derivative before a high priced event would be relatively high, reducing the effectiveness of the product.
- Almost all participants that own open cycle gas turbines (OCGTs or gas peakers) did not support the introduction of a STFM for electricity derivatives. Stakeholders told the Commission that, if required, short term portfolio optimisation can and does takes place through trading on the ASX. If participants want to buy or sell hedging in the short term, they will trade in and out of a cap contract for the current quarter. Participants noted that this only works as the quarterly contract market is the most liquid of all listed products.

The conclusion from the consultation and market analysis is that there is currently limited demand for short term hedge products in the market and that demand is sporadic and bespoke. Therefore, if introduced, the Commission believes a STFM for electricity derivatives would not be actively traded on and hence would not provide any investment signals, or materially improve short term operational decisions, and thus is unlikely to generate any material benefit to consumers.

Further, the Commission noted that market-led processes for establishing new financial products appear to be working. Typically, before an exchange lists a new product, there is evidence of that product trading more frequently on the OTC market. There is recent evidence of new products being developed and traded by brokers on the OTC market, such as solar shape products.

Other processes to improve the operation of the NEM

While the Commission does not consider that a STFM for electricity derivatives should be introduced into the National Electricity Rules, there are several work-streams that are being progressed by the Commission and the Energy Security Board (ESB) that are likely to greater impact on improving market participation options, market efficiency, reliability and security, than an STFM.

The Commission is currently:

- considering a rule change to implement a wholesale demand response mechanism in the NEM. The Commission considers that a targeted mechanism is likely to be a better mechanism to facilitate demand response participation and to improve reliability than a voluntary STFM for electricity derivatives.
- conducting a review into system strength frameworks and primary frequency control, to determine the best options to incentivise the provision of, or procure, required system security services.
- completing a review into the coordination of generation and transmission investment, to facilitate more efficient market pricing as a signal for investment, and improved risk management options for generators to manage congestion.

The Commission is also working with the ESB and other market bodies on projects related to the post-2025 market design, which will also target improvements to reliability and security. These include:

- designing a two-sided market, to achieve greater demand-side participation in the wholesale market, which should have consequent benefits for market efficiency, reliability, and consumer outcomes
- developing a dedicated physical ahead mechanism for improving system security, which may be an efficient mechanism for providing security services in a market with a large number of intermittent generators and more responsive demand
- exploring a series of short term measures to improve AEMO's ability to gain and use additional information to manage the system.

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