Final Determination - Interim Market Liquidity Obligation Guidelines

Retailer Reliability Obligation

August 2019

AUSTRALIAN ENERGY REGULATOR

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1 Background

The Australian Energy Regulator (AER) is responsible for a number of roles in the Retailer Reliability Obligation (RRO) under the National Electricity Rules (Rules).

If the RRO is triggered at T-3, the Rules require the obligated parties in the relevant region to commence making bids and offers for Market Liquidity Obligation (MLO) products on the *MLO exchange* within five business days.

The MLO is a market making requirement designed to facilitate transparency and liquidity in the trading of electricity futures contracts relating to a forecast reliability gap. The MLO operates between T-3 and T-1 when the RRO is triggered and provides a source of qualifying contracts for liable entities to purchase to help meet their RRO contracting requirements. Parties obligated under the MLO are required to post bids and offers, with a maximum spread, on an approved exchange for standardised products that cover the period of the gap.

This document sets out our final decision on the interim Market Liquidity Obligation Guideline following the issues raised by stakeholder submissions through our consultation.

2 Issues Raised In Submissions to the Draft Guideline

The draft RRO rules were published on 8 March 2019. The draft interim MLO guideline was based on those Rules. On 7 May 2019 the Energy Security Board (ESB) released another draft version of the Rules, which resulted in some parts of the draft interim MLO guideline needing to be updated. The release of the Rules also occurred within the consultation period on the draft interim MLO guideline.

Due to the overlapping release dates some submissions referenced sections of Rules that are now outdated.

The AER is not in a position to change the Rules, we can only consider changes to our guidelines. As such, while the AER can acknowledge the stakeholders' perspective this is not a Rule Change process.

This following sections highlight a number of issues raised in the consultation process and the AER's response.

2.1 Obligated parties under the MLO

Section 2.2 of the Interim MLO Guideline sets out our approach to *MLO groups*, *MLO generators* and *MLO nominees*. It also discusses the deeming of *MLO generators* which was initially put forward as an option in the ESB's Draft Rules Consultation Paper and was included in the final RRO Rules.

MLO register

The transitional Rules deem the *MLO generators* and *MLO groups* from 1 July 2019 until 30 June 2021. After that time the Rules define a process to determine the *MLO generators* and *MLO groups*.

Stakeholders submitted that power purchasing agreements and settlement agency agreements, as well as semi-scheduled and non-scheduled generation should be considered when calculating market share, while opposing the use of registered capacity to determine obligated parties, suggested that summer capacity should be used. There were also concerns raised that Queensland should have a minimum of three MLO parties. Concerns were raised that batteries should be excluded from the MLO, and that adjustments or exemptions to the MLO be permitted due to unplanned plant shutdowns or issues that may impact generator availability during the liquidity period.

In terms of the information generators are required to provide to the AER for the preparation of the *MLO register* (including the holders of trading rights), stakeholders considered that generators shouldn't have to divulge information about trading rights and that the AER should rely on publically available information.

The final Rules have set out how obligated parties will be established and confirmed the approach to market share calculation which will determine obligated parties once the

transitional rules cease to apply (30 June 2021). The Rules make it clear that only scheduled generating units can be included.

Following the transitional deeming period, the AER will manage the identification of obligated parties through the development of the *MLO register*. As part of the development of the register, *Market Generators* will have to provide information to the AER about the allocation of generator trading rights. The requirement for the provision of generator information is set out in the Rules. The AER will use this information to ensure the accuracy of the *MLO register*.

Stakeholders requested more analysis on why the 15% threshold was chosen for obligated parties in each region. The 15% threshold was established in the Rules.

Changes to deemed generators

Submissions also raised concerns with transitional deeming arrangements and potential adjustments during the deeming period, disputing deemed units, and the AER's process for adjustments.

There is no dispute resolution process in the final Rules but it does provide the AER a determination process for changes to deemed generators. This process is outlined in the Interim MLO Guideline.

2.2 MLO products

Section 3.1 of the Interim MLO Guideline sets out the AER's approach to *MLO products*, including listing the currently approved products as well as the process for approving additional products in the future.

Currently approved MLO products

Stakeholders submitted that the list of eligible *MLO products* be expanded to include calendar and financial year products in addition to monthly and quarterly contracts. Some stakeholders questioned why call and put options were not included while others suggested including products on other emerging exchanges.

The AER has expanded the *MLO products* beyond quarterly and monthly products to include calendar and financial year products. This provides additional flexibility for parties preferring to offer those products to meet the obligation.

Call and put options are not considered fully firm as noted in the AER's interim Contracts and Firmness Guideline. To avoid exclusions based on exchange-specific products the AER has reframed the approved products so they are not specific to any particular trading exchange.

Approving additional MLO products

Stakeholders were concerned that the AER's process for approving additional *MLO products* may stifle innovation. It was also questioned why the Rules specified a maximum contract unit of 1MWh.

Stakeholders considered that the AER should only be involved if it can demonstrate that the number of trades occurring are not at a suitable level. There was also focus on allowing for innovation, with suggestions that the current wording in the guideline may deter obligated MLO parties from selling new products as they would have a low number of traded volumes to begin with. They suggested the wording on approval of additional *MLO products* in the guideline be changed to 'may' consider the following criteria to rectify this concern.

Rather than defining the products in the Rules and requiring a Rule change to add *MLO products*, the Rules allow the AER discretion to include new products as they are developed. The process outlined in the Rules does not prevent the development of new exchange-traded products and seeks to ensure that approved products meet the objectives of the MLO mechanism. The AER notes that new exchange-traded products must satisfy certain regulatory processes prior to being available on a public platform. The criteria the AER consider for approving new *MLO products* is not onerous. The AER has amended the wording to state the AER 'may' consider the criteria to address these concerns. The size of the contract unit is set out in the Rules and has not been changed.

Contract unit of MLO products

One submission requested the minimum contract limit of an *MLO product* be increased to 5 MW (from 1 MW) to increase liquidity and possibly improve pricing. As this limit is set out in the Rules, the AER's does not have the ability to make this change.

2.3 MLO exchange

To satisfy the MLO, *MLO generators* must offer *MLO products* on approved designated *MLO exchange(s)*. The transitional Rules set out that the ASX24 would be designated as an *MLO exchange* from the commencement of the RRO. Section 3.2 of the Interim MLO Guideline highlights our approach to the approval of additional MLO exchanges.

Stakeholders suggested simplifying the criteria the AER would consider when deciding on an *MLO exchange* and that FEX should be designated as an *MLO exchange* under the Rules. There was suggested replacement text for the transitional rules to allow market operators or trading facilities that hold a current market license issued pursuant to the *Corporations Act 2001* (Cth) be considered an *MLO exchange*. Stakeholders also requested the proposed requirement for public consultation when the AER receives a request for a new *MLO exchange* be removed from the guideline as only the AER can make the decision.

Stakeholders requested more detail on the AER criteria for approving *MLO exchanges*. Specifically, more information about the AER's interpretation of the criterion of 'reasonable costs and ease of trading on the trading facility' and 'volume of trading and diversity of participants.' It was suggested the AER take into account an exchange's potential adequacy of volume of trading and diversity of participants when considering the approval of an exchange. Some stakeholders considered the criterion should be removed as it would be subject to market forces.

The Rules recognise the ASX as the initial exchange for the MLO. The Rules allow the AER to consider applications from parties seeking to be an *MLO exchange*, as per the processes set out in the MLO Guideline. The AER considers public consultation and transparency in

decision making to be good regulatory practice when considering an application for a new MLO exchange.

The AER has expanded and provided guidance on its approach to considering the criteria ‘reasonable costs and ease of trading on the trading facility’ and the 'volume of trading and diversity of participants' when considering an application for a trading facility to be approved as an MLO exchange.

2.4 Bid/offer spreads

Performance of the liquidity obligation requires bids and offers to be made on approved *MLO products* within a specified spread (the spread is NEM region dependent). The spread is set in the Rules and changed between the draft and final version of the RRO Rules. Section 3.4 in the Interim MLO Guideline sets out the AER's approach to the calculation of the bid/offer spreads in the NEM regions.

Stakeholder submissions requested more information on how the spread would be calculated (i.e. would it be based on the offer or the bid price?), with suggestions the spread should be calculated on the offer price. Other stakeholders noted the spreads in the draft guideline and the final RRO Rules were different, while some submissions not agreeing with the wider spreads included in the final RRO Rules and preferred the narrower spread outlined in the draft Interim MLO Guideline.

The AER has clarified in the Interim MLO Guideline that the spread will be calculated on the offer price, providing the widest possible spread for obligated parties. The difference between the spreads in the draft Interim MLO Guideline and the final RRO Rules was a result of the timing of the release of the various documents.

The draft Interim MLO Guideline was based on the draft RRO Rules. This resulted in some confusion as details differed between the guideline document and the updated Rules. This was unavoidable due to the timeframes for developing the RRO guidelines. While some stakeholders expressed a preference for the narrower spreads in the draft Interim MLO Guideline, the final Rules set a wider spread. The AER is unable to change the spread.

2.5 Volume limits

The RRO Rules provide for volume limit thresholds for obligated parties. These thresholds, set at 1.25% (quarterly) and 10% (liquidity period) of traded capacity, serve to ration out liquidity to the market over the two year period between T-3 and T-1. When reached, obligated parties are no longer required to perform the liquidity obligation for the remainder of the quarter or liquidity period. Section 3.5.1 of the Interim MLO Guideline outlines the AER's approach to interpreting the volume limit rules and calculating the progress of obligated parties towards the limits.

A number of stakeholders raised concerns about the process described in the final RRO Rules for determining what trades count towards the volume limits, the issue being that 'buy' or 'purchased' trades are not counted, only 'sold' contracts. Other submissions stated it wasn't necessary for liquidity to be rationed out to the market through the use of volume limit thresholds, while clarification was sought on the meaning of the term 'aggregate transactions' in reference to the volume limits.

The process for determining volume limits and which transactions qualify for those limits is established in the Rules.

The Interim MLO Guideline provides more detail on the interpretation and application of the volume limits threshold, including the concept of 'aggregate transactions', which goes to the qualifying transactions that contribute to the volume limits.

2.6 Performance exemptions

The Rules provide a series of exemptions where obligated parties are not required to perform the liquidity obligation (e.g. where performing the obligation may be in breach of the *Corporations Act 2001* (Cth)). This is in addition to the target trading periods requirement, where obligated parties are able to miss 10 trading periods per month. Section 3.6 of the Interim MLO Guideline provides an overview of the exemptions the AER has proposed in addition to those in the Rules.

Various stakeholders submitted that there should be additional exemptions for obligated parties to perform the liquidity obligation, for example, taking steps to avoid breaching the law by entering a trading halt due to holding price sensitive information.

The AER has added an additional exemption for parties seeking to manage a perceived risk of breaching the *Corporations Act 2001* (Cth) (e.g. not trading when in possession of price-sensitive information that could otherwise be considered insider trading). In order to utilise the additional exemption, as with the existing exemptions, parties will have to provide satisfactory evidence to the AER about the materiality of the risk. Where parties fail to do so, the trading period missed will count as one of the 10 trading periods that can be missed each month. Where an obligated party fails to perform the obligation in 11 or more trading periods in a single month, the AER will consider further action.

The Interim MLO Guideline also sets out the AER's expectation that parties should use the 10 missed trading period allowance each month to manage risks that may not be covered by exemptions, as no evidence is required to use this allowance.

2.7 Liquidity period

Section 2.1 of the Interim MLO Guideline outlines the approach the AER will take to notifying obligated parties at the commencement and end of the liquidity period between T-3 and T-1.

Stakeholders raised issues concerning the liquidity period that were outside the scope of the consultation, as it went to the drafting of the RRO Rules. First, 4A.G.16(c) states that *'a liquidity period commences regardless of whether the AER has published a notice under clause 4A.G.15(a).'* Clarification was sought on what circumstances the AER would not advise MLO generators that an instrument request had been received.

Clarification was also sought on 4A.G.16(d) which refers to a liquidity period operating until *'the date when MLO products are no longer permitted to be bought and sold on any MLO exchange in the relevant region'*, and when products are not permitted to be traded.

The AER's interpretation of 4A.G.16(c) is that the commencement of the liquidity period is not dependent on the AER advising MLO generators that the liquidity period has

commenced. The AER will endeavour to publish notices and advise *MLO generators* promptly if a T-3 instrument is made, and does not anticipate any scenarios where obligated parties are not notified.

In response to the question about when *MLO products* are not permitted to be traded, while the Rules do not specify, the AER takes this to include scenarios where there are no longer any approved *MLO products*, the *MLO exchange* ceases to operate due to licencing or other regulatory issues, or the exchange no longer trades the specific financial products approved as *MLO products*. This is not considered an exhaustive list but is provided as an example for stakeholders.

2.8 Policy

The AER received some submissions that commented on the broader MLO policy as well as other aspects of recent policy undertaken by the ESB and ACCC.

Stakeholders submitted opinions the MLO was not good policy, with some also pointing to concerns with the potential for non-obligated parties to free ride and benefit from the obligations placed on other participants. Concerns were raised about the increased risk and potential significant cost of the MLO for obligated parties, and also noted that in its opinion, increased transparency in the contract market has already been provided.

The issues raised in these submissions were outside of the scope of the consultation and the AER is not responding to these matters in the Interim MLO Guideline.