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ASL

Submitted online



ESEM Co-Design – Consultation Paper

The Australian Financial Markets Association (AFMA) is responding to ASL's Industry-led Electricity Contract Co-Design Consultation Paper.

AFMA is the leading industry association representing Australia's financial markets - including the capital, credit, derivatives, foreign exchange, and other specialist markets. We have more than 140 members, from Australian and international banks, leading brokers, securities companies, and state government treasury corporations to fund managers, energy firms, and industry service providers. Our members include key participants in the NEM and AFMA plays a key role maintaining market documentation for OTC electricity derivatives.

Key Points

- **The co-design process is an effective way to develop ESEM contracts**
 - **Daily movement of the shaping product's windows reduces its value as a hedging instrument**
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The industry led contract co-design process is working well to develop contracts for the Electricity Services Entry Mechanism (ESEM). AFMA would like to thank ASL and members of the working group and its predecessor pilot group for their work developing the ESEM contracts, we also note that a number of AFMA members have contributed to the working groups.

1. Bulk energy and firming

AFMA considers the proposed bulk energy and firming contracts are well designed to both support the development of new assets and to be used as valuable hedging instruments. Caps are a well understood and regularly traded product in the energy market. AFMA considers they will be simple to implement for ESEM firming products and we have nothing further to add to the working group's discussion of the product.

The Regional Reference PPA (RRPPA) removes much of the complexity of the previously discussed dispatch weighted average swap and better allocates risk to the parties able to bear it. We therefore think it will be a better product for bulk energy. We also with the working group that the RRPPA should be an energy only contract and that the ESEM Administrator should not procure any environmental certificates created by the project and support including a cap in the design.

The RRPPA relies on appropriate reference indexes and it is difficult to comment on the product without knowing how the indexes will work. We understand that developing this index is not an immaterial task but as yet there is little publicly available information about how the index will be

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produced and who will publish it. The market would appreciate more information about the production of the indexes before the RRPPA is finalised, including; who will administer it, how it will be calculated for different technologies, how it will take into account advances in technology, how it will deal with degradation of equipment, how will it manage known differences in resources (such as wind in South Australia where there are significant differences in capacity factors due to location) and if there could be multiple indexes within NEM regions.

2. Shaping

AFMA is not convinced that the Dynamic Time of Day Block Spread Swap is the most suitable shaping product.

2.1. Shaping

Our primary concern is that the product is designed to optimise the technical capabilities of batteries to perform in the spot market rather than to provide the most valuable hedging instrument for the market. AFMA agrees with the working group's general philosophy that the role of batteries is to arbitrage between periods of high and low prices and agree that a time-of-day spread is a suitable structure for this. Our concern is that daily variation of the charge and discharge windows introduces significant uncertainty for the buyer about the nature of the hedge cover they have bought.

Parties entering into derivative contracts are typically looking to predictably manage a risk over the medium term (1-24 months). For a hedge to be effective it has to be reasonably well matched to the buyer's risk and our members view is that, for shaping products, it is more important to have certainty about the windows covered by the hedge rather than certainty it will capture the highest priced intervals on any given day. Their view is that while daily adjustments to the windows might optimise the battery's spot market revenue, they undermine its value as a long-term hedging instrument.

We are also concerned that basing the windows on pre-dispatch will introduce incentives for gaming of pre-dispatch, undermining the value of the contract and making pre-dispatch a less useful market indicator. This concern only arises because of the contract's unusual reliance on pre-dispatch and we think could be addressed by setting the windows in another, less dynamic way.

We are aware that the working group is concerned the peak periods that the shaping products are intended to manage are likely to move during the expected long tenors of ESEM contracts and that the dynamism of this contract is intended to mitigate this risk. AFMA acknowledges this is a legitimate concern but considers that the approach taken moves too far in the direction of flexibility, given that macro changes in peak demand are unlikely to occur frequently, making the product less useful as a hedge. Our view is that there should be more certainty about the shaping product's windows. This could be done in a number of ways while still maintaining flexibility over the longer term to ensure the product remains commercially relevant. Some options could include giving buyers more control over the setting of the windows or fixing the windows at the time the contract is resold under the ESEM recycling process, we consider that both of these approaches would give buyers greater certainty about what they are buying. Giving the buyers more control over nominating the windows could be more operationally challenging for the ESEM Administrator than having the ESEM Administrator determine the relevant periods, through a transparent process, in advance of the auction.

2.2. Number of blocks

The consultation paper proposes that shaping contracts could have two charge and discharge windows a day to cover morning and evening peaks. AFMA wonders if it might be more efficient for shaping contracts to have a single daily window. The ESEM Administrator could continue to tender for the services together but either enter into two contracts with successful participants. We consider that this would simplify the contracts and make them more liquid as parties would be able to choose the shaping services they want to procure. We also note that morning peak is a relatively infrequently traded product, that is mainly used in cooler regions during winter, so may have limited application in some NEM regions. As a result, we think it would simplify and improve ESEM contracting to separate the services and only procure morning peak where it is seen to be relevant.

2.3. Degradation

The length of the ESEM contracts means that batteries performance will degrade during their term. As a result, we think the shaping contract should account for degradation. There are a number of ways they could do this including by requiring responses to tenders to include an annual degradation profile. We encourage the working group to explore options that recognise the impact of degradation but do not have an impact on buyers.

3. Force majeure

As noted in the consultation paper derivative contracts generally do not contain force majeure provisions in the same way that physical offtake agreements do and the absence of these provisions can have a material impact on the bankability of projects. AFMA appreciates that the cost of financing for projects is an important concern and that failure to deal with it efficiently is likely to increase the cost of delivering ESEM projects. Despite this we want to reiterate that it is critical to the financial market that the derivative contracts resold by the Financial Management Entity do not contain physical force majeure provisions. Australian electricity derivatives are cash settled financial products that are not linked to the availability or performance of individual physical assets; where parties meet their obligations by making payments rather than operating assets. Introducing force majeure provisions linked to particular assets into the contracts recycled to buyers would undermine the value of the product to buyers and make them less fungible and therefore less liquid. As a result, we think any mechanism designed to replicate the effect of a physical force majeure provision for an ESEM project should be developed outside the recycled derivative contracts, this could include the ESEM Administrator entering into separate risk management contracts with ESEM projects.

AFMA Recommendations

- i. The process for setting RRPPA reference indexes should be developed before the RRPPA is selected as an ESEM contract.
- ii. The shaping service should give buyers more certainty over the windows.
- iii. Morning and evening peak shaping services should be contracted separately.
- iv. The shaping product should deal with degradation in a way that minimises the impact on buyers.

- v. Any mechanism to manage ESEM project force majeure risk should operate separately from the recycled derivative contracts.

AFMA would welcome the opportunity to discuss this submission further and would be pleased to provide further information or clarity as required. Please contact me at lgamble@afma.com.au or 02 9776 7994.

Yours sincerely,

A handwritten signature in black ink, reading 'L. Gamble' in a cursive script.

Lindsay Gamble

Head of Energy and Carbon