Electricity Authority
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Consultation paper – Hedge Markets Enhancements: Permanent Market Making Backstop

Mercury welcomes the opportunity to comment on the "Hedge Markets Enhancements: Permanent Market Making Backstop" consultation paper.

1 Mercury supports a liquid and robust electricity futures trading market

As we have stated in our previous submissions on market making, we support a liquid and robust electricity futures trading market. The futures market provides an essential role in promoting efficient outcomes in the electricity market by enabling the management of spot price risk and informing a range of investment and operational decisions through the discovery of the forward price curve. The benefits accrue to participants across the entire supply chain, including large electricity users, independent retailers and independent generators who may hedge spot price risks using futures contracts directly or benefit from efficient price discovery in negotiating over the counter contracts for difference. Prices indicated by the forward price curve can signal the need for investment. A liquid and deep futures market also supports effective retail competition.

We stand by our comments detailed in our most recent submission in response to the consultation paper 'Ensuring market-making arrangements are fit for purpose over time'. Mercury remains of the view that a commercial approach to market making built on beneficiaries-pay should be a priority as this will deliver the best long-term outcomes for consumers.

2 Electricity Authority should consider parameters for backstop market making

Noting the Electricity Authority intends to codify the transitional backstop into the Code, at least until a full commercial market making model is in place, Mercury would have expected some assessment on whether the design features of the backstop code were optimal. While market making regulation will be iterative we are disappointed there has not been any consideration on whether the backstop provisions could be amended now based on experience over the last few months and also whether additional features should have been included such as fast market rules and provisions relating to periods of market stress.

Mercury has identified some changes to the proposed Code amendment which, in our view, would more likely add to the success and durability of the market making model being pursued by the Electricity Authority. These are discussed below. We are of the view these should be consulted on before the backstop is codified. We would also be willing to provide input to other issues not addressed by this backstop arrangement, such as the need for market stress provisions.

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Regardless of the choice of parameters, the basic design of both the regulatory backstop code and the voluntary marketing making agreements should be identical in order to provide clarity for all market participants, including market makers.

3 Suggested amendments to regulatory backstop

3.1 Bid-ask spreads on near term contracts at 5%; longer dated contracts at 3%

Mercury (and we understand others) have previously explained to the Authority some unintended outcomes have resulted from the decision to narrow spreads in early 2020, particularly relating to liquidity and price volatility in the monthly and short expiry quarterly contracts. The initial depth in the market is often traded in the opening seconds of the daily trading window (which reduces liquidity) and if a market maker picks up volume they do not want, they will then unwind those positions which increases price volatility.

In light of this Mercury is surprised the Authority has not considered whether the current spreads are optimal.

Mercury considers widening the spread to 5% in the monthly and front two quarterly contracts would enhance liquidity and also reduce the cost of providing the market making service. Market makers would still be framing the market but bids and/or offers would be less likely to be hit on market opening resulting in greater liquidity throughout the trading period and reduced volatility in contract prices.

This would be beneficial for market makers, the sector as a whole (due to the costs of providing the service being lower) and to non market-makers who seek to manage spot price risk using futures during periods of high spot price volatility as there will be more volume available to buy/sell.

Therefore, Mercury supports a two-tier spread obligation with all contracts covering the initial six months and the front two quarters to be at a maximum bid-ask spread of 5% with longer dated contracts at a 3% spread (i.e. all contracts beyond six months).

3.2 Exemptions should be set to five days in each of the voluntary and mandatory schemes

The voluntary market making agreements allow market makers five "exemption" days per month (i.e. days where marketing making obligations do not have to be met). Additionally, there are a further 2 exemption days granted within a rolling 90 day period over and above the 5 allowed in a calendar month.

If a market maker exceeded their 5 monthly exemptions and failed to meet their obligations on 3 additional days in a 90 day period, they would be regulated to provide market making services under the backstop Code.

Once that backstop Code applies, a market maker will have only two exemption days per month without facing penalty, and if that is exceeded a Code breach will be deemed to have occurred which will be considered by the Rulings Panel who may enforce a maximum penalty of $200,000 for each additional day the obligations are not met.

Mercury considers that both the voluntary and mandatory schemes should allow five exemption days per month. This better reflects two important aspects of market making under the current and proposed arrangements. Firstly, the current voluntary and proposed mandatory backstop regimes impose costs on market makers and there is no ability to recover these, except for a partial offset via ASX performance fees if obligations are met. Secondly, five days would better reflect the resourcing requirements of market makers and particularly if key staff were on leave or were unavailable to trade. Market makers have a limited number of staff who are trained to provide market making services and employing extra staff solely to meet this requirement would be inefficient and costly. As an example, it is possible a single sickness event (or even a suspected exposure to a Covid19 positive person) could account for both monthly exemption days and leave a market maker the business exposed to a Code breach.

3.3 Mandatory code should cease if conditions are met

The voluntary market making agreements provide for any "additional" exemption days to be cancelled after 90 days subject to the market maker not being mandated to provide market making services in that time. However, if a market maker fails to meet their performance requirements of the voluntary scheme will be subject to the mandatory backstop indefinitely from that point in time on. There appears to be no way for that market maker to revert to the voluntary agreement provisions and no way to receive any compensatory performance fee as it does under the voluntary agreement. This is overly encumbering and is not, in Mercury's view, reasonable or acceptable.

In other words, once under the mandatory Code there is no way for a "regulated" market maker to recover any fee for providing a market making service. This is overly onerous for such a market maker, particularly given the costs of providing such a service. A normal market arrangement would be for beneficiaries of market making to be meeting the costs of having that service provided. Mercury suggests that the ASX performance fee should be worked into the mandatory backstop Code and the Code be amended to enable a complying market maker to revert to the provisions of the voluntary agreement.

Changes to Electricity Industry Participation Code Amendment (Hedge Market Arrangements)

	Voluntary Agreement provisions	**Mandatory Backstop Code provisions**	**Amendments sought**
Bid-ask spread	No more than the greater of 3% or $2	No more than the greater of 3% or $2	No more than 5% for monthly and two front quarter contracts; no more than 3% for all other contracts. Applicable to both regimes.
Exemptions from requirement to quote	Mandatory Code triggered after three failures to meet obligations in a 90-day period	Two trading periods exempted each month	Mandatory Code provisions to match the existing Voluntary Agreement provisions
Cessation of backstop	Exemptions "re-set" following 90 periods of consecutive performance	Not applicable	Market maker reverts to Voluntary Agreement provisions once performance falls back into line with provisions of the Voluntary Agreement.

4 A timetable for progressing commercial market making is needed

The consultation paper mentions progressing commercial market making but no timeframe is given. Given Mercury's preference is to move to commercial market making arrangements as soon as possible we would be concerned if momentum towards this was slow once the backstop market making arrangements were in place. We would like to see a timetable for continuing this work with clear targets for the implementation of a commercial scheme.

Mercury would also appreciate more information from the Authority on how it will amend the Code as it transitions towards the commercial model. In our view any subsequent market makers added under the transitional regime must add to liquidity and depth rather than replacing any of the existing volume obligations.

Mercury would welcome the opportunity to meet with the Electricity Authority to discuss any of the ideas in this submission.

Yours sincerely,

James Flexman

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