Risk Management Options

A response by Synergen

1 Introduction

This note is Synergen's formal response to the consultation paper AIP/SEM/122/06 "Risk Management in the SEM" published by the AIP on 15th September 2005.

The paper sets out the forms of contracts that exist in electricity markets to allow for the management of market risk – in the case of the SEM, to manage energy market risk, and possibly CPM risks.

Synergen anticipates that the primary form of risk management will be through 1 way and 2 way CfDs – particularly in the early years of the SEM. The development of a futures market will be highly dependant whether the pre-conditions for a liquid traded market exist. Any futures market will be very likely to be financial, not physical.

2 Options

Within AIP/SEM/122/06, the Regulator Authorities set out three broad options regarding the development of secondary trading:

1. let the market evolve organically i.e. do nothing;
2. dominant players facilitate a trading environment; or
3. seeding an OTC or futures exchange by the Regulatory Authorities.

These are addressed in turn and then a short summary is provided.

2.1 Organic Evolution

In principle, this is the default option. Where the seeding of secondary trading arrangements has been considered, NETA and the NEM in Australia for example, the decision has been taken not to seed any secondary trading arrangements. As far as Synergen understands the basis for these decisions, the primary arguments have been:

- the decision on what, and how to trade is best taken by market participants;
- regulators, however well intentioned, are not best placed to replicate or pre-empt market decisions;

- the seeding of one exchange is not competitively neutral from a regulatory standpoint;
- participants should not have to pay for arrangements that they do not desire[1]; and
- competition to provide best fit services is desirable, and efficient.

Further, Synergen is unconvinced about the precedent for seeding, particularly in the context of a gross mandatory pool, with licensed enforced bidding, and potentially significant un-contracted volumes subject to mandated Directed Contracts at regulatory determined prices, which are likely to mean that the depth, quality and liquidity in the market will be minimal. On this basis Synergen's view is that the organic evolution (or "do nothing") approach is preferable.

2.2 Facilitated Trading Environment

In this option, ESBPG and PPB, would offer contracts on a proprietary web based platform i.e. an imposed sector solution.

Synergen believes that the imposed solution would lock out other service providers. It is unlikely that the AIME would support more than one secondary market platform. Thus, whilst Synergen can understand the intention to provide short term transparency of available contracts, it is concerned that the specification of form would be detrimental to true market development. Furthermore, Synergen believes that once the trading platform is established with the incumbents, it would deter and stifle further development. On this basis, Synergen rejects the "imposed sector solution" option.

2.3 Regulator Authorities Seeding

As noted in Section 2.1, Synergen does not believe that the pre-selection of a third party provider of a trading platform is appropriate. There is no certainty that this would provide the best long term solution – i.e. the solution that participants would choose. If the wrong provider or product type is chosen, then there would be significant detriment to other secondary trading options. Furthermore, the Regulator Authorities would need to demonstrate a cost benefit for any imposed solution.

Synergen expressly refutes the statement that "***it is not possible that this option would be more costly than the other two options, except possibly in terms of direct costs to the Regulatory Authorities***". This expressly means that costs would be captured by the Regulator Authorities and not

[1] Regulators expenditure is directly recovered from participants. This money may or may not be recoverable from customers – but in a competitive environment it should be. Thus, regulatory expenditure, and its benefits, is ultimately seen by customers.

passed onto customers. Synergen believes that common practice is to recover these costs from licence holders, and thus indirectly from customers.

To the extent that advantages are ascribed to this option in the paper, Synergen believes the stated advantages to be generically those of a secondary trading platform (particularly an exchange). It does not see that these advantages are synonymous with facilitation.

3 Summary

Synergen believes that any form of facilitation / intervention is inappropriate at this stage, and that it would be preferable to allow for the secondary contracts market(s) to develop organically. If there are concerns after the SEM has been established that secondary markets have not developed organically as hoped for, the issue of seeding could be re-visited if participants believe that it would be an effective way to kick start the market.