



MACQUARIE

# Interim Qualifying Contracts and Firmness Guideline

Submission to  
the Australian Energy Regulator

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# 1. Submission to the AER

## 1.1 Introduction

Macquarie Group (**Macquarie**) welcomes the opportunity to provide this submission to the Australian Energy Regulator's (**AER**) consultation on the design of the Interim Qualifying Contracts and Firmness Guideline (**Guideline**) issued under the forthcoming Retailer Reliability Obligation (**RRO**).

Macquarie acknowledges the objective of the Guideline to provide a framework for determining the firmness factor across a variety of contracts used by electricity market participants to support the policy objective of the RRO to contribute to maintaining the security and reliability of the physical grid.

Macquarie would like to highlight that the electricity industry comprises a diverse range of participants beyond generators and retailers, and that there are entities registered as Market Customers who undertake activities in a range of areas beyond traditional electricity retailing services.

Macquarie believes the policy objectives of the RRO would be better achieved if the Final Interim Guideline addressed and clarified the following points:

- Contracts<sup>1</sup> are only incorporated into the calculation of the Net Contract Position where that contract is entered into for the purpose of its activity as a liable entity;
- Contracts which are held on behalf of a third party are explicitly excluded from the calculation of the Net Contract Position; and
- Spot Pass Through contracts are Contracts for the purposes of the RRO.

Providing this confirmation would also avoid unintended consequences for the industry in implementing the RRO. The rationale for these proposed changes to the Draft Interim Guideline is outlined below.

## 1.2 Macquarie's participation in the Australian energy sector

Macquarie participates in the energy industry in various capacities as principal and in support of clients, including:

- as an electricity retailer to large energy users such as industrial and manufacturing operations and market participant in the National Electricity Market (**NEM**);
- as financier for, and investor in, and developer of, renewable energy assets and infrastructure both behind and in front of the meter; and
- as a financial intermediary and provider of over-the-counter (**OTC**) electricity derivatives products in the electricity contracts market as well as a clearing broker for clients' ASX electricity futures contracts.

Many of these activities are undertaken as separate businesses through Macquarie Bank Limited (**MBL**).

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<sup>1</sup> Reference to 'Contracts' in this document is a reference to Qualifying Standard Contracts, Qualifying Non-Standard Contracts, or Non-Qualifying Contracts under the Guideline. That is, broadly any contractual arrangement that could fall in scope for the calculation of the Net Contract Position of a liable entity.

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### 1.3 Meaning of Qualifying Contract and Liable Entity

The Guideline and *National Electricity Law* set out that any entity which is a Market Customer will be classified as a liable entity under the RRO and that any Contract entered into by that entity needs to be included in the calculation of the Net Contract Position of that entity.

MBL, which is a large and diversified provider of financial services, is concerned about the unintended consequences of the Guideline as currently drafted such as the potential reach of RRO obligations into business activities that should sit outside the scope of the RRO. Such unintended consequences would arise because the Guidelines do not address the concept of the purpose and capacity in which a liable entity may enter into Contracts that may contribute to the calculation of that entity's Net Contract Position under the RRO.

For MBL, which is a single entity providing a range of services in the market, the Guideline as currently drafted may result in Contracts from the following unrelated NEM activities being included in the calculation of its Net Contract Position:

- (1) Provision of futures clearing and execution services to clients;
- (2) Provision of futures clearing and execution services to MBL's energy business;
- (3) Provision of OTC hedging services to clients;
- (4) Provision of liquidity and risk appetite in the market; and
- (5) Provision of lending and other finance services to clients.

The provision of the services noted in (1) to (5) above perform an important function in allowing the market to operate effectively and efficiently by supporting market liquidity and therefore aiding effective price discovery. If MBL were not able to provide these services to the market, market participants would not have the same opportunities to manage their exposure to the electricity spot price which would likely lead to increased transaction costs.

Macquarie believes this outcome could be addressed by updating the Guideline to clarify that Contracts shall only be included in the calculation of the Net Contract Position where those Contracts are entered into for the purpose and in the capacity of its activity as a liable entity. That is, only Contracts that are entered into by the liable entity for the purpose of managing that entity's exposure to the volatility of the spot price in its capacity as a liable entity would be considered in calculating the Net Contract Position.

### 1.4 Provision of futures clearing and execution services

MBL provides a range of futures clearing and execution services to entities other than MBL in the market. The provision of these services is undertaken on behalf of clients of MBL on a wholly arms' length basis to MBL's energy business. These include ASX listed swaps, caps and options which the draft Guideline addresses as examples of Qualifying Standard Contracts. MBL also executes futures clearing and execution services for a range of products in a wide range of markets for clients outside of electricity products.

As provider of these futures services MBL holds Contracts in its name on the ASX on behalf of clients in an account identified as a *client omnibus account*.

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Macquarie believes that as these Contracts are not entered into for the purpose of managing MBL's spot price exposure in its capacity as a liable entity, they should not be considered in the calculation of its' Net Contract Position, and that the Guidelines should be amended to clarify this.

In addition to providing futures services to third party clients, MBL's futures business provides clearing and execution services to MBL's own energy business. All futures positions on the ASX on behalf of this business are held in a separate house omnibus account.

The provision of futures services by MBL's futures business to its energy business creates the possibility of Contracts across the two business units being netted against each other when calculating an MBL level Net Contract Position. The Guidelines should ensure that only Contracts entered into for the purpose of its activities as a liable entities are included in the Calculation of the Net Contract Position to avoid any potential issue in this regard.

### 1.5 Provision of OTC hedging services

MBL provides a range of hedging services to clients on an OTC basis. The financial market plays a critical role by enabling energy market participants to manage and exchange risk on a dynamic basis. Financial markets provide risk management alternatives such as ASX futures, OTC broker markets, and bilateral trading and relationships across a range of parties. It facilitates risk transfer with standardised contracts as well as customised transactions to manage more complex risks.

In these instances, MBL, which is considered a Market Customer, is not providing these products for the purposes or in the capacity of its activities as a Market Customer. Consequently, Macquarie believes it would be an undesirable and unintended outcome that Contracts from the provision of these non-Market Customer products be included in the calculation of its Net Contract Position because:

- It would leave to the Contracts beyond the intended scope being captured in the RRO; and
- It puts Market Customers at a competitive disadvantage relative to financial institutions that are not Market Customers and therefore not subject to the RRO.

Macquarie believes these issues could be addressed if the Guideline clarified that only Contracts entered into for the purpose of its activity as a liable entity are in scope. This would also support the policy objective of maintaining a liquid and observable forward market through which Contracts can be traded.

### 1.6 Provision of liquidity and risk appetite

MBL is an active trader in the NEM and has the ability to take on electricity commodity price risk. As noted above, this provision of risk appetite in turn supports the liquidity of the financial market, the effectiveness of price discovery and the ability of a wide range of participants to access risk management products. It also enhances Macquarie's ability to provide OTC hedges to clients referred to above.

These activities are undertaken independent of MBL's activities as a Market Customer, and again the Guideline should clarify that only Contracts entered into for the purpose of its activity as a liable entity would be included in the calculation of the Net Contract Position to avoid the unintended consequence of reducing liquidity and price discovery in the market.

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## 1.7 Provision of lending and finance services

As noted above, MBL is a provider of a range of lending and financial services to entities in the NEM. MBL is concerned that arrangements of a lending or financing nature it enters in to may be regarded as Contracts and included in the calculation of its Net Contract Position even though those arrangements are not entered into for the purpose of its activities as a liable entity.

For instance, MBL is an active provider of reallocation products to entities in the market. Access to these products is important for many market participants to efficiently and cost effectively manage their prudential requirements with AEMO.

As drafted, reallocation contracts may be interpreted under the Guideline as Contracts that need to be included in the calculation of the Net Contract Position. This is because a reallocation consists of two separate components. For example:

- Contract one: as a debit party to an ex-ante energy reallocation, MBL has a contract that increases its exposure to the volatility of the spot price with AEMO as it has contractual obligation to pay AEMO the floating spot price for the energy reallocated.
- Contract two: MBL has a separate contract with the debit party that reduces its exposure to the volatility of the spot price as it is due to receive the floating spot price for the energy reallocated.

The Guideline sets out that non qualifying contracts that increase a liable entity's exposure to the spot price must be included in the calculation of the Net Contract Position, but that non qualifying contracts that reduce a liable entity's exposure to the spot price will not be included. Without additional clarification in the Final Guideline, this could create an interpretation where one side of the reallocation needs to be reported in the Net Contract Position, but the other (offsetting) side cannot be included.

Another example is a prepay agreement, which are a type of commodity finance contract in which the buyer makes an upfront prepayment in exchange for delivery of the commodity over time. For instance MBL may make an upfront prepayment to a generator which is then repaid via the delivery of fixed price electricity until such time as the value of electricity sold to MBL meets the agreed repayment amount. Again this could create a situation where MBL would have a financial contract where an increase in the spot price would reduce its exposure, but the generator would have the opposite position where it may increase its exposure.

Again, Macquarie believes the Guideline should clarify that as these types of arrangements are not entered into in its capacity as a liable entity they should be excluded from the calculation of the Net Contract Position.

## 1.8 Spot Price Contracts

In its capacity as a Market Customer, MBL provides large corporate and industrial (C&I) energy users with customised electricity supply arrangements. These arrangements provide the client with flexibility as to how they manage their energy, and typically provide for a pass through of the spot price to the client under the supply contract itself in conjunction with the ability for the client to access financial hedges as required.

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MBL has observed that across the large C&I market it is common for entities to manage the price risk of their electricity consumption by buying financial hedges separately to the contract for the supply of electricity by a Market Customer. It is also common for entities to enter into long term hedges but then contract for their electricity supply on a shorter term basis.

In this context, MBL has clients that it acts as Market Customer for in its capacity as a liable entity, but where those clients manage their price risk through third parties independent of MBL. Also MBL has clients that it provides price risk hedges for but who have the contract for their supply of electricity with a different entity.

These activities are also commonly undertaken through separate types of contract. The sale of electricity is undertaken through an Electricity Sale Agreement (**ESA**) whereas hedges can be provided directly in the ESA or through a separate International Swaps and Derivatives Association (**ISDA**) Agreement. ISDA Agreements are commonly used to document derivatives trades between two parties and provide benefits including coverage across a range of commodity, fixed income and currency markets in a single document, standardised credit terms between the parties and the ability to net offsetting exposures across the portfolio.

In this context, MBL has clients that it acts as Market Customer for in its capacity as a liable entity under an ESA, and that it manages the price risk for separately under an ISDA.

Macquarie believes the Final Interim Guideline needs to recognise these common contracting strategies for large C&I users. Allowing spot price pass through contracts to be reflected in the calculation of the Net Contract Position of a liable entity would be consistent with the policy objective of the RRO. In Macquarie's view these contracts should properly be regarded as Contracts because they reduce the exposure of the liable entity to the spot price. The Guidelines could contemplate an arrangement where spot pass through contracts entered into by a liable entity are effective where their customer can demonstrate the existence of firm contracts held outside the ESA. They would also accommodate those C&I users who contract energy supply under an ESA separately to hedges under an ISDA, and where those contracts are entered into with different entities.

## 1.9 Opt-In Users

Macquarie supports the ability for large C&I users to elect to manage RRO obligations by being able to opt in to those obligations. However setting the opt-in threshold for a large C&I user at 50 GWh in each region creates an issue for large energy users that have a diversified consumption profile across market regions.

For example, a typical large energy user may have their major production or manufacturing facility (that uses well in excess of 50 GWh) located in one region, but also have a range of distribution or minor processing facilities in other regions (that use less than 50 GWh). In this situation even though the entity is a major energy user with substantial expertise in managing the energy requirements of their portfolio, they are only able to opt-in for those regions that meet the usage threshold. This creates a disjointed approach to managing their energy risk.

This also creates potential issues for large energy users that may wish to utilise grandfathered contracts to meet their obligations. At the moment those entities can only utilise grandfathered

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contracts where they are opt-in customers, however this impedes their ability to utilise grandfathered contracts entered into in regions where they do not meet the opt-in threshold.

Macquarie encourages the AER to provide flexibility in the Guidelines for large C&I users to adopt a common approach to managing energy requirements across their portfolio. Again the ability to recognise spot pass through contracts as a Contract under the RRO would be helpful for large energy users that do not meet the opt-in threshold for a given region to have a mechanism to directly manage their contracting obligations under the RRO.

#### 1.10 Qualifying v Non-Qualifying Contracts

In its draft Guideline the AER sought industry feedback on whether PPAs, internal hedges, interregional contracts and demand response contracts should be classified as standard or non-standard contracts. Macquarie supports an approach that provides industry the certainty of a baseline measurement of firmness for as many contract types as possible. This would allow liable entities to adopt to principles laid out by the AER for that contract type if they wished.

However, in the event that the liable entity regarded the firmness calculated according to those principles as not appropriate in the circumstances, it should be able to take an alternative approach of submitting a calculation of the firmness factor to an independent auditor.

Macquarie submits this approach would be of value for contracts such as PPAs, internal hedges, interregional contracts and demand response contracts which were listed in the draft Guideline as non-standard qualifying contracts. It also suggests this approach would be of value for contracts such as options which were listed in the draft Guideline as standard qualifying contracts but where there may be instances where the firmness attributed to these contracts should be considered by an auditor, for instance where an entity has a portfolio of options in place.



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## 2. Contacts and disclaimer

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