



# Independent Survey of Contract Market Liquidity in the National Electricity Market 9<sup>th</sup> August 2006

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# Survey Objectives

- Submission to ERIG responding to the issues paper on Financial Markets
- Study needs to take account of ERIG's key question:
  - Are financial markets in energy in Australia **acting to support participants in managing their risks**, supporting investment, promoting competition within and between fuels and providing transparency?
- Specific questions of relevance to the data analysis are:
  - What does analysis of the data tell us in relation to the **level of liquidity**<sup>1</sup>?
  - What trends can be observed in the level of liquidity in the financial contracts market within recent times?
  - How does the level of liquidity in the electricity hedge markets in Australia compare to other similar markets?
- It is **not** the objective of the survey to identify whether the market is 'Liquid' or not according to some definition, rather:
  - Is the **level of liquidity** adequate to 'support participants in managing their risks'?

<sup>1</sup> Where Liquidity is defined as: the ability of a market to support participants in managing their risks in an effective and efficient manner

# Approach to Quantitative Analysis

## **Assessment of the OTC and Exchange traded contracts over time**

This will involve obtaining information from the SFE and the active electricity brokers. The type of information we would anticipate sourcing would be an indication of the trend in:

- Number and range of market participants;
- Transparency of pricing and price volatility;
- Volume and size of trades;
- Number and popularity of products traded;
- Average bid/offer spreads and frequency of gaps in bids or offers over a range of products;
- Open interest of contracts; and
- The extent of hedge premiums within the market in terms of hedge contracts being priced above the corresponding pool settlement price.

# Approach to Quantitative Analysis

The 'Level of Liquidity' will be determined by analysing key indicators of derivative market potential and success\*.

## Primary Indicators

- Degree of Vertical Integration
- Presence of Speculators
- Trading Volumes
- Turnover of trades (Churn)
- Bid/Offer Spreads and market depth
- Frequency of gaps in Bids/Offers
- Ability to influence price with trades

## Secondary Indicators

- Market or regulatory impediments
- Barriers to market entry for traders
- Size of physical market
- Price transparency
- Maturity of market (years)
- Perceived hedge premium
- Convergence of paper with physical
- Amount of trading avenues
- Exchange of swap (or physical) for futures activity

\* This is not intended to be an exhaustive list. These indicators will be assessed to the degree that supporting information is available in the time required.

# Qualitative Survey of Market Participants

This will involve conducting telephone interviews with a sample of up to 15 electricity retailers, generators and trading intermediaries. This will be aimed at supplementing the exchange and broker information. These interviews will specifically cover the following aspects:

- The proportion of transactions conducted directly, i.e. not through brokers or the SFE;
- Views on the trends in contract market liquidity;
- Views on risk management for inter-regional trading; and
- Trend in the number of counterparties used.

The telephone interviews will be conducted after the quantitative data analysis is completed. This will allow PwC to specify the interview questions to take into account any trends or issues arising from the quantitative analysis.

# Study Work Plan

