

Australian Energy Market Commission

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Inter-regional settlements residue arrangements for transmission loops - Directions Paper

The Australian Energy Council (AEC) welcomes the opportunity to make a submission in response to the Australian Energy Market Commission's (AEMC's) Inter-regional settlements residue arrangements for transmission loops Directions Paper ("the Directions Paper").

The Australian Energy Council is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

The Directions Paper marks a disappointing turn in the process

The issue at hand has been widely consulted on, first by AEMO starting in November 2022, and then the AEMC, following AEMO's lodging of a rule change which already took account of AEMO's stakeholder feedback. The AEMC reached Draft Determination with a workable solution, similar to AEMO's, that focussed on the allocation of negative settlement residue amongst regions. Now stakeholders are asked to respond to a new, radically different, netting approach, with only a three-week consultation period.

The AEC acknowledges that the AEMC ultimately determines the final rule, and that it is within its remit to consider alternative solutions. However, in circumstances where the rule change proponent—such as AEMO in this case—has undertaken substantial stakeholder consultation, it is important that the AEMC places appropriate weight on the outcome of that engagement. Where a departure from the proposed approach is considered necessary, it should ideally be based on clear and material deficiencies that are identified early in the process. This would provide stakeholders with greater confidence in the value of their input and support more transparent and efficient rule-making process.

The proposed solution will not advance the National Electricity Objective (NEO)

Any rule change passed by the AEMC should be supported by robust evidence that it will advance the NEO, that is, the long-term interest of customers. The Directions Paper does not provide such evidence. It is reliant on an unwarranted assumption that netting will reduce the cost impact on consumers. In practice it will only reduce the directly visible costs passed on through transmission use of system tariffs (TUoS). The AEMC's logic is predicated on their view that there are adequate, low cost, risk management tools available to manage the new risk to which holders of settlement residue auction rights (SRAs) will be exposed as a consequence of the proposed netting solution.

SRAs are a valuable hedging tool. This is specifically because they provide exposure to price differentials between two regions. This allows them to support interregional hedging by participants as a potentially cost-effective alternative to the more straightforward approach of intraregional hedging.

The proposed rule would undermine the value of SRAs because when there are negative settlement residues on one or two legs of the loop, these will be netted off. But the value of these negative settlement residues are not sufficiently predictable to be accounted for by an SRA holder.

The worked example in appendix A is a highly flawed illustration of the issue and the supposed merits of the solution:

- Appendix A states that “the unnetted example is an undesirable outcome because the additional \$60/hour is ultimately recovered from consumers via CNSPs”, but glosses over the fact that this also means the SRA payout is worth an extra \$60/hour and that this is likely to be reflected in the settlement auction revenue, which offsets the negative settlement residue cost. We discuss further below whether the auction revenue represents “fair value” for consumers, but if it does, then neither the CNSP nor consumers are materially worse off.
- It's assumed that gentailer B purchases all available SRAs for VIC-SA even though that is more than required to manage its exposure between those two regions. In practice, it's more likely that some of the SRAs remain unsold.
- The ability of the participants to determine the strike price of the secondary contract between participants that neatly offsets their exposure is simply assumed. In practice it's unclear how the two parties can discover a mutually agreeable price, given that hedging by definition takes place ex ante. There are also more than two participants in the real NEM, meaning it is not obvious that a single appropriate counterparty can be found. In short, the AEMC is simply taking a “leap of faith” that such contracts can be sourced and priced easily enough.

The AEC considers that in practice, and especially in the early periods of full operation of Energy Connect, it will be very challenging for participants to source appropriate secondary contracts. Accordingly, SRAs may not get sold, or may sell for well below their expected payout, as bidders discount their value because of the risk of netting. This latter outcome would cost consumers directly. Meanwhile, market participants will need to find other effective hedging tools, likely less efficient and more expensive ones, and this extra cost will also be passed on to consumers.

If anything, the operation of Energy Connect is likely to increase the utility of interregional hedging (to the extent it remains effective), given that the business case for this interconnection was largely based on displacing gas generation in South Australia.

The net impact on consumer costs is likely to be at best neutral and at worst the loss of effective hedging tools will lead to an increase in price.

To recap, the premise that market participants should bear the risk of negative settlement residues because they are better placed to manage it only holds if they have ready access to appropriate tools to manage it. If they don't, which is the view shared here, then the overall outcome is no better for consumers.

Consumers receive “fair value” in terms of the net payment of settlement residues

In general, the Discussion Paper's assessments of the costs to consumers overlooks that consumers benefit from SRA revenue. Some stakeholders have expressed concern that the auction revenue is lower than the payouts to SRA holders¹. The Discussion Paper states that “consumers have received an average of \$0.72 in SRA proceeds for every \$1 paid to SRD unit holders over the 20 years (80 quarters) from Q2 2004 to Q1 2024”². We take issue with the AEMC's presentation of this issue on several grounds:

- The relevance of whether SRA proceeds represent fair value for consumers to the rule change under consideration is tangential. The issue at hand is what to do about negative settlement residues.
- The AEMC has not attempted to estimate what the fair value of SRA proceeds might be. SRA is a risk management tool and participants bid in to the auction based on expected returns. These may end up being greater or lesser than the amount paid for the rights. Simply comparing auction revenue and settlement payments is an inadequate analysis of this type of instrument.
- Our submission to the Draft Determination did attempt a reasonable statistical analysis of SRA outcomes and concluded that: after an initial period as market participants took time to observe the levels of settlement residues that resulted from the early days of the NEM, it represented an efficient

¹ For example, the EUAA submission to the Draft determination

² Section 6.2

market outcome, and that accordingly, consumers receive fair value for SRA units. The AEMC has not sought to refute our analysis or even reference it in its brief discussion of SRA revenues versus settlement residues.

- The purpose of SRAs is not simply to crystallize the value to consumers, but to support interregional hedging. Participants use this as a hedging tool when it is better value than the alternatives. Thus, consumers in turn benefit from lower retail prices than if this tool was not available. This consumer benefit, while hard to specifically quantify, is not considered in section 6.2.
- If there was cause for concern that consumers were not getting good value from the auctions as things stand, then as explained in the previous section, the introduction of netting is only likely to worsen the ratio of SRA revenue to (positive) settlement residues.

Quantum of issue remains unclear

All parties agree that it is hard to predict the incidence and scale of negative settlement residue in the loop that will be created by Energy Connect. Accordingly, it is hard to predict the impact on consumers and CNSPs of the status quo or the options proposed by AEMO or by the AEMC itself in the Draft Determination, just as it is hard to predict the impact on market participants and SRAs of the netting proposal.

Under the scenario where negative settlement residue is relatively low and stable, then the AEMC's assertion that "Although SRD unit payouts would be lower and may be more uncertain than if the current arrangements were applied, we expect they would correlate sufficiently with price separation to be useful as hedging instruments"³ may well turn out to be true (although market participants are still more than likely to take a "wait and see" approach initially). However, even in this scenario, participants may still need to seek supplementary hedging instruments to offset the reduced value of SRD units, resulting in higher risk management costs. Importantly, low and stable negative settlement residues are also more manageable for CNSPs and do not represent a material risk to consumers.

Conversely, if the "plausible scenario" outlined in the Draft Determination⁴ of almost \$100m negative residue were to eventuate, then that would represent a large amount for a CNSP to manage until it could pass on through TUoS and also a material impost for customers. But equally, such a plausible scenario destroys the value of the SRAs when netting is applied. The payout to a SRA holder for A/C would reduce by around 85 per cent once the negative settlement residue had been netted off proportionally. A participant who had (say), generation in C and load in A and wanted to hedge using the SRAs would find themselves almost fully exposed to the market price cap in region A for that period. The point is that this type of extreme risk is not amenable to straightforward risk management by any party.

TNSPs have raised valid concerns, however, alternative solutions exist

The AEC is sympathetic to CNSPs' preference not to have to manage potentially large amounts of negative settlement residue. As noted above, we don't consider market participants are better placed to manage them either. Additionally, we note the following:

- Netting will reduce but not eliminate CNSPs' exposure to negative settlement residues.
- CNSPs are large well-resourced businesses and presumably are already managing large cashflows, some of which are not fully predictable.
- Network businesses (including distribution NSPs) manage other large unpredictable amounts – the three NSW DNSPs have to collectively pass through \$493m in NSW Roadmap costs in 2025-26⁵.
- NSPs are allowed to pass on such costs directly to consumers even though consumers are not in a position to manage such risks. AusNet Distribution was allowed to pass \$30.1m to its customers

³ P47

⁴ Box 3, p20 of the Draft Determination

⁵ AER, NSW Electricity Infrastructure Fund - Contribution determination 2025-26 - 19 February 2025

(approximately \$30 per customer) of costs related to a single storm event⁶. The costs of operating the NEM—including negative residues—ultimately flow to customers regardless which part of the supply chain is targeted for cost recovery.

To the extent that protecting CNSPs from potentially volatile costs is a priority in this instance, other solutions could be explored if the AEMC could allow time to do so. Perhaps settlement residue cost management would sit better with AEMO for example. Perhaps the way to facilitate risk management of negative residues by market participants is to create a new instrument – for example to auction off the obligation to accept negative residues to the party prepared to accept the lowest payment to do so. Separating positive and negative residues in this way might be preferable to netting. But exploring such alternatives would take more time and resources than a three-week consultation allows for.

Importance of ensuring that existing SRA rights holders can obtain a full refund

If the rule does go ahead, it will materially impact value of existing rights for the period post-implementation. We welcome the Discussion Paper's recognition in section 3.4.2 of the importance of ensuring that rights holder can choose to return their SRAs for this period and be compensated in full.

Any further review of the IRSR framework should await evidence of the impact of upcoming changes

Significant changes to interregional settlement and thus of settlement residues may occur in the next few years due to the following:

- The completion of Energy Connect and the creation of loop flows.
- AEMO's proposed operational changes - if they go ahead.
- The implementation of this rule change – if it goes ahead.
- Conversion of Basslink to a regulated interconnector resulting in new IRSRs between Victoria and Tasmania.
- Outcomes of the review of the NEM wholesale market settings.

The value of any review will be limited unless time has been allowed to assess these changes and their impacts. It will be important to gather evidence regarding the impact of all of these to inform any further review and reform. We note that realistically, any reforms from the NEM Wholesale Market Settings Review may take several years to work through, but an IRSR review should at least be cognisant of the planned reforms.

Any questions about this submission should be addressed to David.feeney@energycouncil.com.au.

Yours sincerely,



David Feeney
Group Manager, Wholesale and Environment
Australian Energy Council

⁶ AER, AusNet Services distribution cost pass through - September 2024 storm