

Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

21st June 2019

Submitted via e-mail to: RRO@aer.gov.au

Dear Sir/Madam,

Draft Interim Qualifying Contracts and Firmness Guideline
Reference: Trackit 64876

The Australian Energy Council (the “**Energy Council**”) welcomes the opportunity to make a submission in response to the Australian Energy Regulator’s (“**AER’s**”) *Draft Interim Qualifying Contracts and Firmness Guideline Consultation Paper*.

The Energy Council is the industry body representing 23 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia, sell gas and electricity to over ten million homes and businesses, and are major investors in renewable energy generation.

Introduction

The Energy Council appreciates the limited time the AER has to implement the Draft Guideline and the large scale of the task of creating a framework for assessing the complexity of contracting in the National Electricity Market (“**NEM**”). In the Retailer Reliability Obligation’s (“**RRO’s**”) formative stages, and until such time as the Final Guideline is on foot, it will be important for the AER to be pragmatic in its assessment of liable entities’ nett contract positions, and subsequently their compliance.

Determining instrument firmness for a RRO is a novel task, for which the AER must conceive new approaches. In every judgement it undertakes when exercising this role, the AER should also revert back to the original objective of the RRO, which is to ensure a market process exists whereby sufficient reliable capacity is available to meet a forecast peak. The mechanism chosen is that of requiring each retailer to purchase “firm” contracts, one year ahead of the peak, to meet that retailer’s share of that peak. In achieving the ultimate objective, the primary focus should be upon the incentives each contract creates on the sellers of contracts.

Discussion

Default Firmness Methodologies

The Energy Council appreciates the work the AER has done in preparing default firmness methodologies for standard qualifying contracts. The Energy Council disagrees that such default methodologies “must be applied when assessing the firmness of standard qualifying contracts”.¹ Instead the Energy Council suggests that such methodologies should be default, but not mandatory, and consequently, like the treatment of non-standard qualifying contracts, standard qualifying contracts should be allowed to have firmness factors which differ from the default, by approval of an auditor after proper, defensible justification.

Firmness Methodology for Standard Electricity Swaps & Caps

In line with considering the ultimate intent of the RRO, the AER should be thinking about how the selling of an instrument is likely to require the investment in reliable physical plant. A standard sold swap or cap clearly does this. The Energy Council agrees that a cap with an extremely high strike price such as \$14,000/MWh would probably not, and therefore cap strike price is a relevant consideration to contract qualification. As such,

¹ Consultation Paper, p.12

the Energy Council agrees with the AER's statement that "strike prices below 5 per cent of the market price cap (MPC) align with the intention of the RRO",² – although in the absence of any analysis, the origin of the 5 per cent is unclear, and a different threshold may be just as suitable. For example, an expensive technology, such as compressed air storage, may justify a significantly higher cap price. The Energy Council therefore suggests that as part of the development of the Final Guideline, the AER conducts analysis to determine the appropriate level for strike prices which align with the intention of the RRO.

However the seller of a cap with a strike price that covers the majority of possible spot prices, say for example one with a \$1,000/MWh strike, would still probably need firm capacity of 100% of the sold volume to prudently back it, otherwise it would risk exposure to wholesale market volatility and subsequent financial impairment. A \$1,000/MWh strike might be a legitimate product for the owner of a very high Short-Run Marginal Cost ("SRMC") physical position (such as some industrial demand-side response) and, as high-priced SRMC capacity is as good as any other capacity in meeting the intent of the RRO, there is no reason to discount it. Thus, strike prices up to the highest legitimate SRMC should be acknowledged as delivering full firmness.

However in recognition that near MPC strikes would probably not incentivise generation, the Energy Council supports the firmness of the cap progressively declining from the point of the highest legitimate SRMC as the strike price approaches the MPC, but questions why the firmness factor declines as a curve in the shape chosen, rather than, say, in a straight line, or a differently-shaped curve. Further advice from the AER is sought on this point.

Firmness Methodology for Options

The AER appears to have approached this section incorrectly, by focussing on the instruments' value to the buyer, rather than the incentive it places on the seller to invest in physical capacity.

A seller of the typical swaptions and captions traded in the NEM exposes itself to the instrument being exercised and therefore on foot during the period of market peak. Thus, options sellers will want to be sure they have the physical capacity to back it at the time of the peak. This is exactly what the RRO is seeking to achieve.

The key matter, from the perspective of the RRO's ultimate objective, is whether a prudent seller would hold some kind of direct or indirect recourse to physical capacity in the case of the option being called by the buyer. Taken from that perspective, calculation of the value of an option from the point of the buyer, as proposed in the paper, may not be necessary. An approach could be for the AER to consider, in the circumstance of any option being called (irrespective of probability of calling), what physical capacity is necessary to back the resulting swap or cap. In that regard, the same approach being proposed for traded swaps and caps could be employed to contemplate the called swap or cap.

Non-Qualifying Contracts

The Energy Council regards it as a shortcoming in the Rules as drafted that non-qualifying contracts can only be assessed for their effect to *increase* a liable entity's exposure "to the volatility of the spot price in a region during the gap trading intervals".³ It makes little sense that non-qualifying contracts which reduce a retailer's exposure to the spot price cannot be considered favourably in determining a nett contract position.

Once the firmness of a contract has been determined, it should be treated symmetrically with respect to buying and selling. Thus, a sold contract that has been determined by the Methodology as not providing price protection should not be deducted from a retailer's nett position.

Symmetry of treatment has the added benefit of ensuring the Bespoke Firmness Methodology is developed without bias. Where there is uncertainty in whether a contract should be included or not, it is not a conservative course of action to exclude a particular type of contract, as the contract would be removed from the sales side of the transaction as well as the purchase side of the transaction.

² Consultation Paper, p.21

³ Proposed National Electricity Rule 4A.E.2(c)

Bespoke Firmness Methodologies

The Energy Council endorses the AER's approach to bespoke firmness methodologies, and strongly supports the AER not interpreting "manifest error" as allowing the AER the discretion to overturn a firmness factor approved by an auditor where the AER disagrees with the auditor's approach.⁴

The Energy Council considers this a very important part of the guidelines as there are a myriad of contractual innovations in the NEM, which should continue to be encouraged. Bespoke firmness methodologies should be readily accessible for all contracts that do not fall into the standard categories, as they might still achieve the RRO's objective. For example, an arrangement by which a retailer tolls gas through a power station in return for its electricity offtake meets the RRO's intent, as it allows the retailer to gain access to physical capacity, therefore it would be appropriate for it to be counted as meeting the RRO.

The Energy Council also supports the establishment of an Auditors Panel, and suggests that the AER include a mechanism by which auditors can be added to the panel more often than the quadrennial review proposed.⁵

Power Purchase Agreements and Generation within Vertically Integrated Retailers

The legislation and the rules provide no guidance on how to treat non-standard qualifying contracts, therefore bespoke firmness methodologies must be developed for the different arrangements. The Draft Guideline sets out a range of inputs when liable entities are calculating the firmness factor for power purchase agreements and internal generation, one of which is recent historical performance. The Energy Council submits that recent history is not a definitive indicator of future performance, and may be affected by future considerations, such as planned plant refurbishment, therefore while recent performance may be useful as an indicator, the Draft Guideline should provide sufficient latitude for it to be discounted in an entity's determination of firmness factor, since it may not accord with future business plans.

Portfolio Treatment

The consultation paper allows liable entities to treat portfolios of options in aggregate,⁶ and generation within vertically-integrated retailers as a portfolio as well.⁷ It therefore appears logical for the AER to allow liable entities to treat any combination of qualifying contracts (such as power purchase agreements ("PPAs"), or contracts from intermittent generation combined with "firming" contracts) as a portfolio also, where the entity can demonstrate sound reasons for doing so, e.g. geographical diversity or commonality of terms & conditions. While the consultation paper indicates this is acceptable,⁸ the requirement for individual firmness factors to be assigned to each PPA contradicts this approach, and the Energy Council recommends that individual firmness factors not be required if retailers opt for the portfolio approach.

The Energy Council would also like to clarify the treatment of the different companies within a corporate group assessed as being a vertically-integrated retailer. For example, a parent company may have a number of different entities within its corporate group, and its retail arm and its generation arm may be different legal entities. In this sense the retail arm is the liable entity, but its total generation capacity is zero, since these are controlled by a separate, albeit related, entity. The consultation paper does not address the distinction,⁹ and the Energy Council recommends that the wording be clarified to consider this common business structure. It may be helpful if a mechanism was established by which all compliance obligations could be assumed by another entity within the corporate group, thereby simplifying the calculation of liabilities, and streamlining the reporting of nett contract position.

Wherever the AER lands in its treatment of portfolios, it needs to ensure that all liable entities are treated the same, and there are no anomalies which encourage artificial corporate restructuring.

Demand Response Products

In common with the non-qualifying contracts discussed above, liable entities with demand response arrangements with major customers may not have triggers linked to specific spot prices, which therefore excludes them from consideration as qualifying contracts. Instead, they may be called upon at the discretion of the liable entity, subject to certain notice periods or other conditions. It is therefore appropriate that, subject

⁴ Consultation Paper, p.31

⁵ p.32

⁶ p.24

⁷ pp.35-36

⁸ p.32

⁹ p.36

to the arrangements being registered with the Australian Energy Market Operator's Demand Side Participation Information Portal, such contracts be counted in retailers' nett contract positions.

Nett Contract Position Reporting

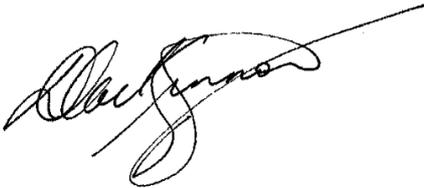
In its submission to the Retailer Reliability Obligation Draft Rules Consultation Paper,¹⁰ the Energy Council suggested that the requirement under proposed Draft Rule 4A.E.6(c)(1) for a Director to certify a return be mollified by specifying that an Authorised Officer (who can warrant that he or she has the necessary authority) be able to do so instead. This would streamline the administrative overhead for market participants without diminishing the scrutiny the statement will receive within each business, and should be considered by the AER for future editions of the rules.

Conclusion

In conclusion, the Energy Council suggests that liable entities be given the option to use, for any contract, either default firmness factors, or bespoke firmness factors based on methodologies approved by auditors after appropriate justification by the liable entity. In addition, there are a number of areas set out above where additional latitude in the Guideline would assist retailers in meeting both the spirit and the law of the RRO, thereby incentivising the availability of firm generation (or its equivalent) in the NEM.

Any questions about this submission should be addressed to the writer, by e-mail to Duncan.MacKinnon@energycouncil.com.au or by telephone on (03) 9205 3103.

Yours faithfully,



Duncan MacKinnon
Wholesale Policy Manager
Australian Energy Council

¹⁰ Available at

<http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/AEC%20Response%20to%20National%20Electricity%20Rules%20Amendments%20-%20Retailer%20Reliability%20Obligation.pdf>