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Submitted by email: info@esb.org.au

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Consultation on Retail Reliability Obligation Draft Rules Consultation Paper

AGL Energy (**AGL**) welcomes the opportunity to make a submission in response to the Energy Security Board's (**ESB**) Retail Reliability Obligation (**RRO**) Draft Rules Consultation Paper (**Draft Rules**).

AGL is one of Australia's largest integrated energy companies and the largest ASX listed owner, operator and developer of renewable generation. Our diverse power generation portfolio includes base, peaking and intermediate generation plants, spread across traditional thermal generation as well as renewable sources. AGL is also a significant retailer of energy, providing energy solutions to around 3.5 million customers throughout eastern Australia.

In addition, AGL is continually innovating our suite of distributed energy services and solutions for customers of all sizes. These behind-the-meter energy solutions involve new and emerging technologies such as energy storage, electric vehicles, solar PV systems, digital meters, and home energy management services delivered through digital applications.

Basis for the development of the Retailer Reliability Obligation

AGL was supportive of the National Energy Guarantee (**Guarantee**) framework as put forward by the ESB in August 2018, largely because of its attempt to create greater certainty on the integration of energy policy with emissions reduction targets, which we consider will be a long-term imperative for energy markets in Australia. However, the implementation of the Guarantee as a bipartisan policy response to bring certainty to the direction of the NEM has failed to eventuate.

Since the Guarantee was consulted upon last year, the COAG Energy Council has decided to not proceed with the emissions requirement, instead implementing only the Retailer Reliability Obligation (**RRO**) component of the Guarantee framework.

At the same time, the federal Government has embarked on a number of other policies to address concerns regarding reliability and prices in the NEM. These include the Underwriting New Generation Investment scheme¹, the proposed 'big stick' legislation², proposed default retail market prices, and a number of expedited transmission projects. The impact of these policy interventions is significant, and acts to deter the kind of investment that the RRO is intended to promote.

There is a risk that implementing the RRO without finalised Procedures and Guidelines during a period of significant energy market reform and policy uncertainty may simply increase risk and compliance overheads on energy market participants, rather than unlock the capital required to drive additional investment in new generation projects that will reduce prices for customers.

Short term and transitional impacts

¹ See <https://www.environment.gov.au/energy/underwritingnewgeneration>

² Treasury Laws Amendment (Prohibiting Energy Market Misconduct) Bill 2018; further information available at https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bld=r6256



Prioritising a prescribed level of firm contracting over the efficient dispatch of resources is a significant change to operation of the wholesale market. If this transition is not implemented carefully, the outcome might be reduced spot market efficiency without any new investment in supply.

In the long-term, we consider that the design of the RRO could theoretically support an optimal supply mix to meet reliability outcomes, especially when coupled with an emissions requirement for generation. However, this theoretical design requires a practical long-term policy commitment to replace existing generation with generation from more flexible sources in an orderly manner, taking into account other energy market objectives such as increasing interconnection and the amount of variable renewable energy in the system.

While in the short-term a well-designed RRO could feasibly incentivise more demand response and extend the life of some assets that are becoming increasingly underutilised, the additional responsibility on retailers and market customers to manage system reliability could also create a significant burden on liable entities who are unable to manage that risk.

In our view, underlying Rules and Guidelines that support the RRO should therefore not be set so strictly that compliance with the RRO creates a further significant distortion to the operation of the market. Rather, the RRO should be designed in such a way that it meets its primary aim of allocating the cost of emergency reserves to participants that choose to remain unhedged during periods of peak demand.

Interaction with broader market reform

We note that the ESB has also recently embarked on a significant and important piece of work to assess the optimal NEM design to secure the supply of the full range of services required to deliver a secure, reliable and lower emissions electricity system at least-cost to customers. It is intended that this review be complete in order to have a fit-for-purpose market design implemented by 2025. For this reason, our responses to the consultation on the RRO Draft Rules favour settings that will enact a mechanism that is as simple and non-distortionary to the market as possible.

We consider that simplification will lead to lower costs on consumers as a result of a decreased compliance burden and risk overhead on liable entities. RRO settings that are less prescriptive in the first instance will also result in a decreased risk of material price increases and competition concerns. During a period of significant change in the national energy market, these are critical considerations to keep in mind for policy makers.

South Australian derogations

We also note that the Government of South Australia is currently considering derogations and amendments to the proposed Draft Rules that may have material impacts on the way that participants must comply with the Rules and the operation of the RRO as a whole.

The uncertain impacts of these derogations, which the SA Government has not consulted upon broadly with industry, creates additional risks for energy participants when assessing these Draft Rules. The risk of different timing requirements for SA must be recognised as a significant barrier to realising the benefits associated with the broader RRO policy aim of creating investment certainty and stability in the forward market.

AGL remains committed to supporting policy that provides clear long-term investment signals for the electricity sector. We look forward to engaging further with the ESB on a fit-for-purpose market design to apply from the mid-2020s. Further feedback in relation to the detailed operation on the RRO is contained in **Appendix A** to this submission.



Should you have any questions in relation to this submission, please contact Aleks Smits, Manager Policy & Research on 03 8633 7146, or myself on 03 8633 7252.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'Eleanor McCracken-Hewson'.

Eleanor McCracken-Hewson

Senior Manager Policy, Research & Stakeholder Engagement, AGL Energy



Appendix A – Further feedback on draft rules for the RRO

Forecasting the reliability requirement

In our submission to detailed design issues for the RRO³, we noted that the most appropriate metric to trigger a capacity shortfall is likely to be a projection of significant unserved energy (**USE**) above that required by the reliability standard. The ESB disagreed with this view, stating that the RRO should be triggered when there is a T-3 forecast that the 0.002% reliability standard will be exceeded.

In practice, this means that it is much more likely that the RRO will be triggered, and that a much larger reliability gap than is realistically likely to be observed will be predicted, due to the construction of ESOO forecasts. The purpose of the ESOO has traditionally been to highlight development opportunities and gaps in committed projects. For the purposes of the RRO, this means that it is much more likely to be triggered as AEMO will be using its base case assumptions, which do not include network and generation projects that are probable, but uncommitted at the time of the forecast.

Binding the trigger of the RRO to the Reliability Standard should also consider the impact of future changes to the Reliability Standard, which are currently being consulted upon.⁴ In our view, it would therefore be prudent to allow some discretion in how the trigger is assessed against a standard that may be calculated or set differently over time.

We note that there is no proposed allowance for non-material breaches of the Reliability Standard to be addressed by other means or for the AER to exercise discretion not to trigger the RRO. For example, as the Rule currently stands, the RRO could be triggered with an immaterial Reliability Gap as small as 1 MW, which could easily be covered by action that is far less onerous than the RRO, such as the registration of a demand response contract by a market participant. In our view, the AER should have the power to consider the materiality of the breach of the Reliability Standard in its decision to proceed with issuing a T-3 Reliability Instrument in accordance with an assessment as to the long-term interests of customers.

Under the RRO framework, the AER will be subsequently developing a 'Forecasting Best Practice Guideline' that will make the provision of certain information mandatory, with a civil penalty attached for non-compliance. However, this guideline will only be finalised by the end of 2019 for the 2020 ESOO. We support the development of this guideline but note that prior to its completion, AEMO should still publish information on the construction of scenarios and sensitivities and identify any Reliability Gap using the neutral or most likely scenario, rather than a scenario that does not take into account realistic factors beyond revenue sufficiency and economic plant retirement.

This includes the new provisions that are required to be considered in the ESOO (i.e. Rule 3.13.3A(2A), (4A), (4B), and (4C)). Where this information has not been incorporated into this year's ESOO and a forecast breach of the Reliability Standard is nonetheless determined, transitional arrangements should consider if the failure to include that information provides sufficient justification to not proceed with a T-3 Reliability Instrument even if there is a forecast Reliability Gap.

As the ESOO is becoming a much more critical document it is important for AEMO to be very clear about its assumptions and clear about the inputs and scenarios that it is presenting. We look forward to providing input into the proposed AER Forecasting Best Practice Guideline and AEMO Reliability Forecast Guideline.

³ <https://thehub.agl.com.au/articles/2019/01/submission-in-response-to-the-esbs-consultation-on-the-retailer-reliability-obligation>

⁴ See the Reliability Panel's consultation paper 'Definition of unserved energy', (4 April 2019) available at: <https://www.aemc.gov.au/sites/default/files/2019-04/Consultation%20paper.pdf>



Further information regarding the ESOO forecasting process is also available in AGL's submission to AEMO's 2019 Planning and Forecasting Consultation paper.⁵

Timeframes for requesting and making reliability instruments

Forecast peak demand periods are currently likely to be during hotter summer months (November to February). However, some consideration should be given to forecast USE events that may occur outside of this timeframe as a result of unexpected or poorly forecast events or changes in demand profile and supply availability. There may also be merit in AEMO adjusting the timing of its ESOO process to ensure adequate lead time is provided to meet all RRO compliance obligations.

We consider that any additional information that is required to be incorporated in the ESOO could be requested through AEMO's forecasting process, which ensures that participants provide information to AEMO that provides a more robust understanding of the expected market outlook. The ESB has also recommended that this obligation attracts a civil penalty. In that context, we do not consider that the proposed notice of closure needs to be extended, as long as participants are complying with the proposed Rule 3.13.3A(e). The extent to which these two obligations interact, however, may need to be considered further by the ESB, AER, and AEMO as a part of the forecasting guideline development and subsequent process.

Liable entities

The draft NEL (Section 14D) defines a liable entity as an entity who is a Registered Participant (a retailer or other market customer). We consider there are good arguments to exclude certain Registered Participants under certain conditions if their operations are not likely to benefit the scheme more generally.

For example, generating facilities that are also registered as market customers (such as batteries and pumped hydro but also some other generators) may draw significant demand from the grid from time to time but are not likely to be doing so at periods of peak demand. Requiring these facilities to be hedged to their potential share of POE50 load is unlikely to materially support the objective of the RRO while imposing significant cost on their operations. We consider an option for the AER to exclude a market participant from compliance with the RRO under certain conditions would be a prudent addition to the framework. These conditions could include representations regarding the nature of the participant's operations during periods of peak demand.

Principles for firmness adjustment of qualifying contracts

Principles for the firmness adjustment of contracts are critical in the operation of the RRO. To the extent possible, we therefore consider that Rules and Guidelines should be flexible in their assessment of qualifying contracts. Overly prescriptive criteria could have a material impact on the way in which participants seek to meet their RRO obligations, which could have resulting impacts on the structure of investment in the NEM and the operation of the NEM financial market.

We agree with the broad criteria set out by the ESB in assessing the firmness of contracts but note that these principles should not stifle contracting innovation and the ability for market participants to dynamically manage their portfolio to reduce costs for customers, including accessing interregional generation and other derivatives to meet their obligations. Principally, retailers should be able to manage their exposure to the wholesale market in an efficient and lowest-cost manner, rather than be subject to additional contracting requirements that will impose costs on consumers for no material benefit.

⁵ <https://thehub.agl.com.au/articles/2019/03/2019-planning-and-forecasting-consultation>



In particular, calculation of the firmness of a retailer's hedging portfolio will need to consider the ability to utilise financial products that reflect interconnector availability, such as Settlement Residue Auction (SRA) instruments, especially in a more highly interconnected NEM that will be increasingly dependent on variable renewable generation. Retailers are unable to influence interconnector availability and opportunities to access firm products may change as more energy is sourced from other NEM regions over time. While the market may evolve over time to offer more diverse firming products that take account of these changes, in the short-term, the AER should consider the possible financial implications of retailers not being able to use SRAs and weather derivatives to cover their position. With particular regard to the possibility of a Reliability Gap in South Australia as soon as summer 2020-21 and the short period of time to comply with this obligation, the utilisation of interstate generation will be key to maintaining contracting efficiency and should be adequately considered in the development of firming methodologies.

On balance, we consider the options presented for methodologies to assess firmness are reasonable and provide flexibility for participants, although we note that the treatment in particular of interregional products may need to be considered more carefully. However, this is not to suggest that the process will not be difficult for participants. There is likely to be a considerable administrative burden on liable entities to restructure their contract portfolio to meet firmness obligations, which may translate into higher transactional and compliance costs. In our view, it is not clear that these costs will be recovered through lower wholesale prices under the current design of the RRO, at least in the short-term.

We also note the significant risks associated with a generic assessment of participant firmness factors prior to any worked examples of this methodology being consulted upon in more detailed with participants. We consider that much more significant consultation needs to occur on an indicative firmness methodology, including detailed assessments of the impact of assignment of various firmness factors, to ensure that the firmness methodology does not create unanticipated impacts on participants and potentially consumers through increased pricing.

Firmness factors for some contracts may also change over time as market conditions change and firmness methodologies may therefore also need to be revisited on an annual basis. Rather than prescribe this process, we consider that this may raise an argument for a more flexible compliance approach to assess firmness rather than attempts to comprehensively set methodologies that are unlikely to be resilient to change.

Given these complexities, we consider that as guiding principles, methodologies to assess firmness should be flexible and resilient to change, not be overly harsh or prescriptive, limit administrative overheads and compliance costs for participants, and not stifle contract innovation and negotiation.

Market Liquidity Obligation

Mandatory market-making

In our view, the design of the RRO does not necessitate the creation of a mandatory market-making obligation, and we continue to question the basis for an obligation that will seek to artificially inflate trading volumes based on the very fixed obligations proposed in the Rules. We remain concerned about the effectiveness of market making in reducing prices based on evidence from overseas markets such as New Zealand, Singapore, and the United Kingdom, which suggest such obligations are more likely to increase risks for market participants without increasing supply.

The focus by policy makers on simply increasing the level of flat swaps traded as a percentage of overall demand does not adequately consider the changing nature of electricity markets.

Particularly in the case of South Australia, there are a number of underlying reasons for this trend that will not be resolved by creating mandatory market-making obligations. For example, in South Australia there is



no baseload generation and an increasing proportion of supply is being provided by variable renewable generation that is not able to provide firm derivative products, let alone firm swaps and caps.

Increasing the traded volume of these products is therefore unlikely to improve the outlook for supply or the amount of these products that are available. We therefore question the need to progress the MLO through the RRO Draft Rules process and would support removing the MLO from the Draft Rules entirely and deferring the creation of a market making obligation until such time as it has been adequately considered by the AEMC. Alternately, we support the proposal in the consultation paper that the MLO should not be triggered where sufficient voluntary market-making is already occurring in the region or where a demand for those services is not expressed by market participants. Lastly, we do not consider that the MLO should be required to remain as an obligation when the Reliability Gap has been shown to be met following a T-2 updated forecast, as the intention of the MLO to assist in meeting the objectives of the RRO mechanism will have been achieved.

Further analysis on the conditions to make these assessments could be determined by the AEMC in their ongoing review of voluntary market-making arrangements, or by the AER in their guideline following such time as these issues have been adequately considered.

Additionally, we consider that further analysis should be included in the ESB's Draft Rule process in outlining why increased turnover of exchange-traded products will meet the objectives of the RRO to improve reliability and reduce prices over the long-term, as this has not been made clear throughout the analysis provided to support the RRO.

MLO eligibility

A fundamental basis for the MLO should be that generators that are not participating in the market during the forecast Reliability Gap should not be MLO Generators under the Rules. A participant should not be required to sell contracts that are based on the capacity of a unit that will no longer be in service and has not been included in AEMO's forecasts.

In our view the identification and nomination of MLO Generators and their capacity could be informed by information provided to AEMO as a part of its ESOO process and should match those inputs. For example, if AEMO's ESOO is based on modelling that includes generator closure, new generation, or adjustments to operating capacity, then these developments should be reflected in the MLO framework. In this regard, MLO generator eligibility should reflect the conditions of the forecast Reliability Gap for which parcels are being traded.

A better indication of MLO Generator capacity may be the forecast summer scheduled capacity of available generation units in the NEM,⁶ which is representative of the inputs that AEMO uses for its ESOO forecasts. While these do change over time, they provide the most accurate basis for available dispatchable capacity during the Reliability Gap, which matches the obligation of the MLO. It should also be noted that registered capacities are not likely to be reflective of the actual maximum quantity of contracts that can be sold out of a facility, which will be less than the total registered capacity due to factors such as auxiliary load.

With regard to the specifics of the MLO obligation, we consider that these may be better placed within a guideline that is administered by the AER rather than within the Rules where changes cannot be made as readily. This would provide greater flexibility on the settings for an untested market obligation, in particular as we consider the basis for the proposed settings on volumes, bid and offer spreads, traded limits, and participant eligibility is not based on detailed modelling or experience.

⁶ Available at: <https://www.aemo.com.au/Electricity/National-Electricity-Market-NEM/Planning-and-forecasting/Generation-information>



Timings and sessions

We consider that the proposed five days to begin trading within a liquidity period (Rule 4A.G.16(a)) from the date of the Reliability Instrument is much too short. Given that the MLO will be in place for a period of years, we consider that the benefits of allowing participants greater time to prepare for MLO trading will be outweighed by any benefits associated with commencing this obligation within five days. A more appropriate and realistic timeframe might be at least one month.

Similarly, we consider there is no benefit to having 35/25 trading sessions of 30 minutes each per month as proposed in the draft Rules, as the MLO could quite adequately be serviced by much fewer trading windows that would come with lower compliance costs to participants.

MLO Groups are not established as trading houses and the ESB has not made a case for why this onerous level of trading windows (i.e. twice a day for almost every business day) would be preferable to fewer windows that could be more easily managed by MLO Groups. We consider that 30/20 trading sessions should be considered as a maximum, which would allow participants to manage operational requirements while still meeting the benefit of the scheme. A more preferable level that would still meet the objectives of the MLO would be one trading window per day and a maximum of 20 sessions per month. Forward trading desks at companies managing physical asset and customer exposures perform a wide range of operational functions, and this should be balanced with any new requirements imposed by an MLO.

While this would change the alignment with the ASX scheme, we consider that the test should be to show that the outcomes of the MLO require more onerous compliance overheads on participants than a voluntary scheme to be effective – we do not believe this is the case – and we would argue that a mandatory scheme should begin with less onerous obligations, which could then be adjusted following review. This may be another reason not to prescribe untested detail in the Rules but rather within a guideline.

Finally, there is also a minor inconsistency on the timing of the sessions between the MLO and the proposed voluntary ASX scheme in terms of availability during the trading window. In our view the Draft Rules should clarify an allowance in availability to allow for flexibility with making, managing, and adjusting bids and offers during the trading window, or other uncertainties that occur during the trading window. Clarity that the 'reasonable time' provision in the Draft Rules would include these allowances would be helpful.

Product types

Some clarity should be provided on whether a participant can offer either base and peak futures or cap futures. There is ambiguity in the Draft Rules as to whether or not there is an obligation to offer a combination of those products. It should be clarified that an MLO Generator can offer any type of eligible MLO Product at its discretion.

Bid and offer spreads

We consider that the bid-offer spread proposed by the ESB is far too narrow and is not supported by any rigorous analysis. The proposal from the ESB for far narrower spreads is not predicated on long-term analysis that is publicly available, and at any rate, is more reflective of voluntary trading conditions, where participants who naturally want to buy provide a bid and participants who naturally want to sell provide an offer, resulting in tighter apparent spreads than would be realistic in an imposed market.

Furthermore, although the ESB references the ASX's market making agreement in the design of the MLO, this equivalency between the two schemes is not reflected in bid offer spreads. In the ASX agreement, these spreads are set at the greater of 5% and AUD 1.00 for base load contracts (with the exception of South Australia, set at 7%), and for base load cap contracts the greater of 10% at AUD 2.00.



As a sophisticated and knowledgeable trading exchange, we consider that the ASX is well positioned to provide a more realistic trading range for MLO Products based on their underlying knowledge of trading markets. Alignment with the ASX scheme would be preferable for participants to reduce divergence from multiple market-making schemes and again we consider that a mandatory scheme should not be more onerous than a voluntary scheme.

Mandating market making to conform to this tighter spread, on both sides of the spread for the one MLO party, is not warranted. In our view, the bid offer spread should be set at a sufficient spread to encourage liquidity in trading from all participants, not discourage it.

Net sales limits

Net sales limits for MLO Groups seem reasonable. To avoid ambiguity, we consider that the Draft Rules should clarify that additional volume above daily limits also counts towards quarterly and annual net sales limits (i.e. net sales limits are not capped at the daily or quarterly limit if participants elect to trade beyond those limits).