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BY EMAIL

Energy Security Board
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Dear Board Members

Submissions on the National Energy Guarantee draft design consultation paper

Thank you for the opportunity to provide submissions on the National Energy Guarantee (**Guarantee**) draft design consultation paper released on 15 February 2018 (**Consultation Paper**).

The proposed design of the Guarantee has the potential to significantly affect existing contracting arrangements in the National Electricity Market (**NEM**). Ashurst, as a law firm, wishes to provide submissions from a legal perspective and based on our experience in the electricity sector.

1. **ABOUT ASHURST**

Ashurst is consistently recognised as possessing one of Australia's leading energy practices. The Ashurst Utilities team has gained specialist experience in the electricity sector from involvement in some of the most significant Australian transactions and projects in the energy industry since the early 1990s.

Ashurst advises clients on all aspects of the energy sector including electricity, gas, renewable energy, mining and petroleum. We advise energy project sponsors, developers, investors, generators, transmission and distribution network operators, retailers and customers on energy project, transactional and commercial work, as well as electricity regulatory work.

2. **THE IMPACT OF THE GUARANTEE ON THE EXISTING CONTRACTING MARKET AND THE EXISTING FINANCIAL DERIVATIVE MARKET**

2.1 **Structure of the NEM spot market and the derivative market**

As the Consultation Paper notes, the NEM is a gross energy spot market in which:

- (a) generators are dispatched in five-minute dispatch intervals by the Australian Energy Market Operator (**AEMO**) in merit order based on bids submitted in pricing bands and forecast electricity demand;
- (b) retailers and registered large users (collectively referred to as Retailers throughout this submission) pay a spot price to AEMO for each MWh of electricity consumed, and AEMO then pays the spot price to generators for each MWh of electricity generated; and

- (c) the spot price is calculated on a half-hourly basis as the average of the price of the last MWh to be dispatched by AEMO in each dispatch interval within that half-hourly period (although we note this will change to match the five-minute dispatch interval from 1 July 2021).

As the spot price can fluctuate significantly between trading intervals and regions (ie the various States) in the NEM, many generators and Retailers separately enter into over-the counter (**OTC**) derivative transactions and ASX futures to manage spot price risk. These transactions typically take the form of swaps and caps (and some swaptions).

This derivative market has developed over the last 20 years with the aim for the OTC products and the ASX products to be as fungible as possible. This benefits trading in the market and ensures higher liquidity (including subsequent trades).

These products for the most part do not have a direct relationship with the generation source of the counterparty or the physical consumption of the Retailers' load. This aids in the fungibility of the products.

2.2 **Introduction of a physical link to the derivative market**

Although these contracts mitigate financial risk to Retailers and generators, under the proposed design of the Guarantee set out in the Consultation Paper, we expect that a number of new physical obligations will need to be incorporated into these essentially financial contracts. These would include the emissions levels and dispatchability of the underlying generators.

This will be a significant change from the current pure financial derivative market that has developed in response to the design of the NEM as a gross energy spot market.

The operation of the OTC market and the ASX Futures Exchange is predicated on the fungibility of the instruments. As a fundamental principle, the more homogenous the products are, the greater the fungibility and this promotes the liquidity in the market. There is a real risk that contracts which are linked to generation, rather than being purely fiscal arrangements, will mean that submarkets could be created. This is likely to impact liquidity and could drive up prices in the wholesale market (even as the spot price is reduced) because participants cannot use these transactions as easily to manage their risks.

We submit that the Board undertakes more detailed assessments on the impact of the Guarantee on the electricity derivative and futures markets and ensure that it does not unintentionally result in a distorted market or a higher wholesale price (as opposed to spot price), which could potentially result in a higher priced outcome for consumers.

2.3 **Uncontracted position**

In respect of the emissions requirement, we have some concerns about the proposals in the Consultation Paper regarding uncontracted positions.

In terms of managing risk, we are aware that participants choose to be uncontracted for part of their generation or load portfolio and therefore are exposed to the NEM spot price for that part of their portfolio. This is consistent with the portfolio management and is a good risk management tool.

The proposals noted in the Consultation Paper (see item 3.3.5 of the Consultation Paper) may penalise these participants for adopting this current risk management tool. We believe that one of the unintended outcomes is that the market may become highly contracted (or an allocated market in the case of the gentailer arrangements). There is the potential for this outcome to produce a higher wholesale price, which could result in a higher priced outcome for consumers.

3. **INTERACTION BETWEEN THE EMISSIONS AND RELIABILITY REQUIREMENTS**

We submit the Board provide further explanation as to how the emissions and reliability requirements are anticipated to work together. For example, if a Retailer chose to comply with its reliability requirement by financing new, reliable gas-fired generation, to what extent will it be required to finance new, intermittent renewable generation to ensure it continues to satisfy its emissions requirements?

This could particularly be an issue if the Retailer was unable to procure sufficient demand response to meet its reliability requirement and so was forced to invest in new, emissions-intensive generation to avoid penalties under the reliability requirement.

4. **THE PRACTICALITIES INVOLVED IN FORECASTING THE RELIABILITY GAP**

The Consultation Paper describes a number of different forecasting components associated with the reliability requirement including the initial forward assessment of the reliability gap, the updated forecasts and triggering the reliability requirement. These components are all interrelated, moving parts.

We submit the Board should carefully consider:

- (a) the forecast approach, specifically whether AEMO will forecast on the basis of a particular event (eg a one in ten year peak demand event) or to meet demand over a forecast period;
- (b) the forecast period (if that is the approach taken), specifically whether it is a period of months in the year (eg the summer period) or a few hours in each day (eg the peak period in the afternoon), the answer to which can result in very different technological responses;
- (c) what the consequences are if the forecasting is wrong (noting that if the reliability requirement is to drive efficient market outcomes, Retailers must be able to rely on the forecasting);
- (d) how frequently the forecasting is updated; and
- (e) whether the forecasting is independently tested.

If the forecasting is wrong, we submit there is a real possibility of a zero warning period before the reliability requirement is triggered (even a one year period would likely be insufficient as new projects would not expect to reach commissioning by the time the reliability gap commenced). If the reliability requirement is triggered without sufficient lead time for Retailers to respond as required, we submit this could result in ad hoc, short-term strategies which may not achieve the objectives espoused by the Board and could drive adverse market behaviours.

Ultimately, inefficient markets and adverse market behaviours are likely to lead to increased prices, which may be passed on to the end customers.

5. **TRIGGER POINT FOR THE RELIABILITY REQUIREMENT AND THE IMPOSITION OF MANDATORY INVESTMENT OBLIGATIONS**

We note the Consultation Paper recognises that there will need to be a point at which a forecast reliability gap triggers the reliability requirement which requires Retailers to procure new reliable generation. This possible "trigger point" could either be a short term point (between three to twelve months before the forecast reliability gap) or a long term point (between three to five years before the forecast reliability gap).

We submit that given that:

- (a) reliable generation will likely include generation from coal, gas and hydro sources (and potentially battery storage); and
- (b) obtaining environmental and other project approvals for new coal, gas and hydro power plants can often take in excess of three years (in addition to a lengthy construction timetable),

then if the trigger was set as anything less than five years, a reliability gap would almost inevitably occur in line with the forecast, because new projects would likely not reach commissioning by the time the reliability gap commenced.

6. **THE BOOK BUILD OPTION**

The Consultation Paper raises the possibility of a "book-build" option as an alternative to a market driven solution in response to the identification of the reliability gap.

We are concerned the book-build auction concept may result:

- (a) in the deferral of market driven outcomes (or in fact a lack of them being brought to market), essentially waiting for the book build process to be implemented (we believe there is a potential that both Retailers and new investors could take this stance); and
- (b) the auction price becoming the price setter which may not necessarily reflect efficient pricing and costs, and which may ultimately be passed on to the end consumers.

We note the Consultation Paper outlines the concept of the book-build option, but at this stage the Board has not provided detail about the other terms and conditions of these contracts, relevantly whether there will be default terms and conditions set by the Commonwealth. We submit the Board should carefully consider the competition and productivity impacts of these default arrangements, and the extent to which the Commonwealth truly wishes to intervene in the market (and potentially set default terms and conditions).

7. **AEMO AS THE PROCURER OF LAST RESORT**

The Consultation Paper suggests as a possible option that AEMO should carry out the procurement process if the reliability gap is not met.

We submit that the Board should carefully consider:

- (a) for whom AEMO would be procuring this investment;
- (b) whether AEMO is best placed to efficiently procure any necessary investment; and
- (c) the consequences of any pricing inefficiencies (while AEMO may allocate the cost to Retailers, these costs may ultimately be passed on to the end customers).

8. **LEGAL COMPLEXITIES ASSOCIATED WITH ALLOCATING THE RELIABILITY REQUIREMENT TO LARGE ENERGY USERS**

The Consultation Paper also contemplates allocating the reliability requirement to large energy users who are not registered as a "Customer" under the National Electricity Rules (**NER**). In our experience large energy users increasingly adopt a wide range of sophisticated pricing mechanisms (for which only a proportion of their load may be subject to spot pass-through arrangements) as part of their electricity procurement process,

contract for varying terms (which may vary from one to ten year terms) and may have one or more retailers.

How compliance for large users will be monitored, without the disclosure of highly commercially sensitive information to the Australian Energy Regulator (**AER**), remains an open issue. The allocation of the reliability requirement to large energy users has the potential to place significant compliance obligations on this group, increasing their costs and it is unclear as to the extent of the benefit that will be derived.

We submit that the Board carefully consider the legal complexities in implementing such an arrangement if it does decide to include this allocation aspect in the final design of the Guarantee.

9. **THE INTERPLAY BETWEEN THE EMISSIONS REQUIREMENT, THE RET SCHEME AND SAFEGUARD RULE**

9.1 **Operation of the existing legislation**

We note the Consultation Paper does not address the intended interaction between the RET Scheme and the emissions requirement.

We submit the failure to do so gives rise to numerous issues including:

- (a) whether the generation from generators who create large-scale generation certificates under the RET Scheme is also able to be counted towards meeting the Retailer's emissions requirement (ie can the same 1MWh create both a large-scale generation certificate and be counted towards the Retailer's emissions requirement);
- (b) are small-scale technology certificates able to be used (in the same way as the suggestion in the consultation paper that Australian Carbon Credit Units or international emissions units can be used); and
- (c) are existing generators to be "grandfathered" under the RET Scheme by 2020 and the RET Scheme effectively closed (as was suggested in an earlier Board paper on the Guarantee).

We also note the Consultation Paper does not address the intended interaction between the *National Greenhouse and Energy Reporting (Safeguard Mechanism) Rule 2015* (Cth) (**Safeguard Rule**) and the Guarantee.

We submit that the Board further consider this interaction, cognisant of the national application of the Safeguard Rule in contrast with the Guarantee, which is only proposed to apply to the NEM. The failure to ensure an alignment between the Safeguard Rule and the Guarantee could increase compliance costs which will likely ultimately be passed on to end customers.

9.2 **The emissions requirement beyond the NEM**

It is unclear what arrangements are intended to apply to non-NEM generators after the introduction of the Guarantee (eg whether the Safeguard Rule will be abolished with respect to NEM generators but retained with respect to non-NEM generators).

There are a number of non-NEM generators that are both low-emissions and reliable generators and which could benefit from a nationally consistent scheme, or clarification of the intended arrangements, especially given that emissions are a national issue.

We suggest that consideration be given to the integration of, at least, the emissions requirement on a national, rather than NEM, basis.

10. DISCLOSURE OF COMMERCIALY SENSITIVE INFORMATION TO REGULATORS

We note the Consultation Paper places significant focus on the disclosure to regulators of otherwise confidential financial hedging contracts between generators and Retailers.

We submit it is important to ensure that the regulators have sufficient mechanisms in place to prevent the disclosure of commercially sensitive information (eg pricing) to other market participants.

11. PENALTIES FOR NON-COMPLIANCE WITH THE RELIABILITY REQUIREMENT

We note the Consultation Paper invites discussion on whether the "efficient" costs of centrally procuring resources should be used as an enforcement tool (in place of a financial penalty).

We submit there are a number of issues to be considered with this approach including:

- (a) whether centrally procured resources really can lead to efficient pricing outcomes (see comments above);
- (b) whether the allocation should be based on the Retailer's forecast load (forecast load always differs from actual, and at the time the reliability requirement is triggered it will be triggered based on a forecast); and
- (c) whether the penalties will be on a sliding scale; and
- (d) what is meant by the statement "the AER will have sufficient discretion to administer the penalties".

While it is important to have discretion, we submit that there should be parameters around the exercise of that discretion.

12. THE NATIONAL ELECTRICITY OBJECTIVE SHOULD BE AMENDED TO ACCOMMODATE THE GUARANTEE

The Consultation Paper does not address that the National Electricity Objective (**Objective**) is inconsistent with the Guarantee (ie there is no reference to an emissions requirement in the Objective).

The Objective is applied in a number of aspects of the administration of the NER. We submit that a careful review of this interaction is required so as to ensure that:

- (a) there are no unintended misapplications of the Objective; and
- (b) decision making is not inappropriately affected by taking into account the emissions requirement.

Ashurst would welcome the opportunity to discuss these submissions further with the Board. If the Board would like to discuss any aspect of these submissions, please contact any of Paul Newman, Partner on (07) 3259 7061 or Paul.Newman@ashurst.com; Tanya Denning, Partner on (03) 9679 3364 or Tanya.Denning@ashurst.com; or Peter Limbers, Partner on (02) 9258 6486 or Peter.Limbers@ashurst.com.

Yours faithfully



Ashurst