8 March 2018

Energy Security Board

By email only: info@esb.org.au

Dear Sirs

Consultation Paper: National Energy Guarantee

CS Energy welcomes the opportunity to respond to the Consultation Paper on the National Energy Guarantee (**NEG**). CS Energy supports the intent of the NEG in ensuring that there is a balanced approach to energy security, emissions and price. In response to the paper, CS Energy makes the following submissions[1]:

- The proposed mechanism for the Reliability Guarantee contains a number of forecasting and compliance requirements with penalties levied for non-compliance. Further detail on how this will operate is required to ensure unintended consequences of the compliance requirements are avoided;

- This, together with the introduction of a Strategic Reserve will need to be clearly defined to ensure the risk of excess supply is well managed; and

- An unintended consequence of the Reliability Guarantee which will need to be considered is the potential for it to reduce participation from the demand side, potentially impacting on the achievement of demand side response objectives.

Ideally, to improve reliability, real time price signals would be enhanced, allowing the market, including the demand side, the maximum flexibility and discretion to respond[2].

You will find attached CS Energy's discussion on the options put forward in the Consultation Paper.

Yours sincerely,

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[1] These views are the views of CS Energy only and should not be construed as those of the Queensland Government. These submissions are provided as input into the consultation process only. Without further detail it is difficult to take considered position on the NEG.

[2] Refer to CS Energy's submission to the AEMC in respect of the 5 minute settlement rule change

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The mechanism for the Reliability Guarantee contains forecasting and compliance requirements with penalties levied for non-compliance. Further detail on how this will operate is required to ensure unintended consequences of the compliance requirements are avoided

Penalties for non-compliance could result in unintended consequences

The Consultation Paper clarifies that retailers may be exposed to the cost of AEMO procuring reserves if retailers have not adequately procured enough contracts (or built enough capacity) to meet the Reliability Guarantee.

The paper also discusses the allocation of efficient costs and the ex-ante approach. CS Energy notes the following in respect of those concepts:

- the Paper doesn't explain how efficient costs are to be determined, other than to make reference to the NEM's price ceiling, the estimate of the value of customer reliability ('VCR') or the cost of AEMO procuring to meet the gap. These values may not necessarily represent the efficient cost of providing reliable electricity supply; and
- although the ex ante approach will require retailers to contract or invest in advance, for the long term, this presents risk for retailers which should be considered as part of the design. These risks include the financial risk that might arise where investments are made and then AEMO forecasts are revised down; and the risk of compliance costs following a decision not to contract or invest.

The system design will need to ensure that the signals for investment or contracts against the penalty cost are well balanced to allow efficient choices for retailers.

Physical contracts

The consultation paper considers contracts being linked to physical capacity, "*to provide more assurance that the required investment that is needed to cover the gap is actually occurring*", but expresses concerns about forward physical contracts reducing liquidity. CS Energy agrees with this concern and is of the view that financially settled contracts can encourage the physical scheduling of assets, and therefore moving to a different form of contract is not necessary.

Day-ahead markets and forecasting

In comparison to physical contracts, the Consultation Paper also discusses other measures that *"could provide market participants and AEMO with greater certainty around day-to-day operational outcomes"* and are more *"direct approaches to promoting the availability of physical capacity when it is needed"*. These measures include changes to forecasting and the introduction of a day-ahead market. It is CS Energy's view that any certainty to the operator through such a market would come at a cost from participants, who lose flexibility to re-dispatch as the market closes.

In addition, a day-ahead market would rely upon AEMO to schedule and dispatch plant in a more efficient manner than current Market Participants. The argument for this is that AEMO has insight into system security or reliability that Participants do not have access to. In CS Energy's view, Participants with a profit motive are the most motivated to achieve efficient outcomes.

Accordingly, CS Energy's view is that a day-ahead market is not the most appropriate mechanisms to resolve the reliability concern.

Vertical integration and contracts such as PPAs

Retailers may try to manage their exposure to the costs of AEMO providing for reliability by investing in their own capacity or entering into power purchase agreements ('PPA') which are linked to an asset or part thereof of some kind. The development of power stations and to a lesser extent, the negotiation of PPAs entails significant risk for retailers and could be beyond the financial capacity of some existing and potential new entrant retailers.

Whilst this has proven to be a strategy that many retailers have adopted, it is unlikely to the sole approach to hedging a retailer's exposure. This is because it would be rare for a retailer to "make" their electricity all the time, when it precludes the benefit of "buying" from others at cheaper prices.

CS Energy's concern

Retailers will be encouraged, by the risks of penalties they will face, to enter into contracts, required possibly well in advance (up to 5 years, depending on the trigger used) and for a risk averse quantity (1 in 10 year forecast demand (10POE), depending on forecast used), thus leading them to pay more than would notionally be the case given the risks they currently face in the NEM auction.

These risks are the retailers' own forecasts of demand and price (including the risk of the price meeting the market price cap) and the ability to hedge the position when they wish to. The risks that retailers may face as a result of the introduction of the Reliability Guarantee are the 10POE demand, the potential costs allocated from AEMO's procurement, the deadline by which they must contract set by the trigger date and AEMO's subsequent timing of actions. These factors will all increase the demand for contracts, potentially increasing the price of those contracts and ultimately the cost for consumers. These factors should all be considered in the detailed design of the framework.

The Reliability Guarantee, together with the introduction of a Strategic Reserve will need to be clearly defined to ensure the risk of excess supply is well managed

The Consultation Paper discusses in section 5.9 how the 'compliance date', which is where AEMO steps in as the procurer of last resort, is intrinsically linked to AEMO's proposed Strategic Reserve.

In order to encourage the market to provide the Reliability Standard, rather than AEMO, the Rules presently limit the use of RERT to:

- situations where forecast unserved energy is in excess of the Reliability Standard;
- periods within 10 weeks of dispatch; and
- buying reserves from consumers, typically with costs in excess of the price cap.

However, the Consultation Paper suggests that for RERT/Strategic Reserve purchases there will be increases to both the time horizon (3 years or more) and forecast quantity (MTPASA 10% POE, which is assessed as a one-in-ten year expectation of demand). It is possible therefore that the RERT/Strategic Reserve will be more expensive, and funded by consumers who would not necessarily have made the same decision to pay when faced with real time price signals (both short and long term). It will be important to ensure that the design of the RERT/ Strategic Reserve considers these potential distortive effects.

An unintended consequence of the Reliability Guarantee which will need to be considered is the potential to reduce participation from the demand side, potentially impacting on the achievement of demand side response objectives

An unintended consequence of the proposal may be the exclusion of potential suppliers, such as demand side participants, who wouldn't ordinarily contract 3 – 5 years ahead in the wholesale market.

This, together with AEMO's methods to fill the "reliability gap" irrespective of whether the demand occurs will all increase the demand for contracts, with the potential impact of increasing the market price above the normal price.

In addition, it is likely that only a small amount of demand side participants will have the ability to enter into RERT contracts with AEMO.

These factors will need to be further considered in the detailed design of the demand side response framework.