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Friday, 5 April 2019

Dr Kerry Schott
Chair
Energy Security Board

Dear Dr Schott

RE: Retailer Reliability Obligation Draft Rules

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Energy Security Board's draft rules for the Retailer Reliability Obligation (RRO).

About ERM Power

ERM Power is an Australian energy company operating electricity sales, generation and energy solutions businesses. The Company has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load[1]. A growing range of energy solutions products and services are being delivered, including lighting and energy efficiency software and data analytics, to the Company's existing and new customer base. The Company operates 662 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland. www.ermpower.com.au

General comments

ERM Power has consistently argued that the development of the rules underpinning the RRO need to ensure that both the reliability and affordability objectives are met in a way that does not further entrench the market power of the big gentailers. We have stressed that a poorly designed RRO could damage competition and result in less choice and higher costs to consumers.

The draft rules acknowledge these risks and in our view are broadly designed in such a way as to mitigate these risks, particularly for commercial and industrial users. In particular, the ESB appears to have taken on board much of the feedback that we and other stakeholders have provided. Still, we consider that there are ways to further minimise the risks of unintended consequences and we propose alternative approaches to achieve this.

These draft rules build on the draft amendments to the National Electricity Law that the ESB consulted on in late 2018. ERM Power wants to note that there are further key design elements still to be developed once the final rules are formed. We are particularly interested in the development of the Australian Energy Regulator's (AER) guidelines that will help to underpin the ways in which liable entities are able to comply with the Obligation and how AEMO's forecasts will establish a reliability gap in terms of time and MW.

We stress that the guidelines and AEMO's approach to determining a gap period need to reflect the objectives of the policy – to ensure that reliability is met in the most efficient way possible that minimizes the costs to consumers. This must remain as a principal consideration as guidelines are developed.

In particular, we are concerned by AEMO's seeming preference to set gap periods which maximise the use of standard contracts and minimise the need for bespoke contracts. While there is a more liquid market for standard contracts such as quarterly caps and swaps than bespoke products, it is important that AEMO sets the gap period

[1] Based on ERM Power analysis of latest published financial information.

only for periods that gaps are forecast to occur, so that liable entities have the opportunity to meet the Obligation in an efficient manner. A targeted and narrow gap period window will still allow for existing standard contracts to be used but will also incentivise a wider range of technologies to be available in the right places at the right times to target the specific periods of concern. It allows storage technologies like pumped storage or batteries to be fully available as well as guiding demand response providers of the times to be ready for dispatch. Contract markets will respond accordingly, developing products that meet the requirements of managing the gap periods and will in turn provide liquidity and price transparency. Large users who have opted-in to the Reliability Obligation may also be able to structure their business operations to shift demand to other times of the day. It is not the role of AEMO to define a gap that suits financial markets; financial markets will evolve to manage the risks of the gap period, whenever it is.

In contrast, a broad requirement fails to provide this targeted guidance meaning it is difficult for existing and prospective generators, new technologies such as demand response or batteries, and large users to plan their availability accordingly. This approach will add significantly to costs for consumers, undermining the goal of this policy to encourage reliable supply and reduce energy costs.

The submission which follows provides more detailed comments on specific elements of the draft rules.

I welcome the opportunity to discuss this submission further. Alternatively, please contact General Manager, Corporate Affairs Michelle Barry on (07) 3020 5145 or mbarry@ermpower.com.au.

Yours sincerely,

Jon Stretch
Managing Director and CEO

Adjustment of contract positions within T-1

ERM Power has argued that retailers need to be able to adjust their contract positions inside the T-1 window in order to maintain contract market liquidity, avoid stranding customers and support retail market competition. We are grateful that the ESB has taken steps to address these concerns.

We acknowledge the work the ESB has done to design a mechanism that encourages commercial and industrial users to contract early but allows a backstop to ensure they are not effectively 'locked out' of the market in the event they haven't. We understand those concerns are the justification for allowing retailers to adjust their net contract position under certain circumstances. However, we consider that there is a class of customers that the Board has not considered in its assessment.

In particular, we are concerned that large customers who do not recontract in advance and come out of contract within the T-1 period will potentially be required to change retailers under the current provisions. This is because a retailer appears to only be able to adjust its contract position where it has taken on large customers with peak demand less than 30 MW. For recontracting customers, an incumbent retailer would be taking a large financial risk to enter into hedging arrangements for a customer which had not recontracted by the contract position day. If they are unable to adjust their contract position should the customer recontract, then they will likely be unable to make the customer a new offer, thereby reducing the customer's choice of retailer. To resolve this problem, ERM Power recommends that recontracting customers should be classified in the same way as existing large customers under 30 MW.

Furthermore, retailers are obliged to continue as the customer's financially responsible market participant (FRMP) until they choose to leave. In theory, a customer could pass all compliance risk onto the retailer, as the liable entity under the RRO, without giving the retailer the opportunity to manage that risk.

Finally, we support the ESB's decision not to require liable entities to maintain their contract positions after T-1. Retailers need the flexibility to manage pool exposure risk by constantly rebalancing their portfolio to match conditions that can be observed closer to real-time; retailers will have a better understanding of customer load, weather conditions and supply risks a month out compared to one year in advance. Had this requirement been retained it would have posed broad risks to retailers as well as to those who had taken on customers within the T-1 period and therefore needed to adjust their contract position. Had the ESB not changed this position, these retailers would have been unlikely to find sellers of contracts and thus would have been at risk of non-compliance.

This would have created a situation where large customers coming out of contract in the T-1 window would potentially be limited to contracting with a small subset of retailers able to take on this risk. Small retailers looking to grow would also have faced a limit on their ability to acquire customers. We consider that the ESB has therefore taken a sensible step that will help to underpin contract market liquidity and support retail competition. We strongly urge the ESB to retain this provision in the final rules.

Net contract position

Based on the draft rules, ERM Power understands the rationale for requiring parties to report their net contract position as:

- the number of MW of all contracts, adjusted for firmness, that reduce the buyer's exposure to the spot price,
- less the number of MW of qualifying contracts that increase its exposure to the spot price,
- adjusted for the effects of non-qualifying contracts that increase the liable entity's exposure to the spot price.

We understand that this is to avoid the situation where an entity purchases a large volume of qualifying contracts and then backs out of this position by selling different contracts to other parties.

Yet there are difficulties in assessing the total impact of this. For instance, it is reasonable to assume that if a non-qualifying contract increases the seller's exposure to the spot price it should in theory reduce the buyer's exposure to spot price volatility, which raises the question as to why it is classified as a non-qualifying contract. Other contracts can be used to manage the risk of low spot prices, but these appear to be caught up by these provisions. For example, a retailer may enter into an Asian put option to protect itself from low spot prices if its load fails to meet its one-in-two year peak demand exposure, but this would be unlikely to trigger in periods of tight supply. Based on the current drafting, this retailer would likely face a reduced net contract position as a result.

We would encourage the ESB to be more specific on the purpose of section 4A.E.2 to provide greater clarity to liable entities as to how the net contract position will be determined.

Market Liquidity Obligation

The design of the RRO is such that while retailers *must* contract, generators *may* contract. Consequently, ERM Power has argued that the design of the Obligation needs to recognise the risk that generators could economically withhold contracts from the market. We therefore fully support the ESB's proposal for a Market Liquidity Obligation (MLO) which would require large generators to make bids and offers during a gap period. We consider that the ESB's proposed approach is a balanced one that supports market liquidity and the ability of small retailers to access contracts on reasonable terms, without adding significant risks to those required to make the market.

We also note that market makers are afforded the protection of being able to buy as well as sell, which is a principle that we also support.

We do not believe that the alternative approach discussed by the ESB – that the decision to trigger an MLO would be based on the scope of voluntary market making arrangements – can adequately manage the issue of contract market liquidity. The risks that the ESB notes – different liquidity or terms, a sudden end to the voluntary arrangements, and limited monitoring abilities – make it clear that the best option is for the proposed MLO to be implemented.

Additionally, we consider that the proposed deeming arrangements for the first two years of the RRO, the use of registered capacity, the approach to determining trading rights holders, and the control and influence test are all appropriate for the MLO at this stage.

Assessment of an instrument request

The draft rules set out that a T-3 or T-1 reliability gap can only be rejected by the AER on very specific grounds and, as stated in the stakeholder forums, that the AER will not be undertaking modelling to recreate AEMO's results. We understand that modelling is not within the AER's role and that timeframes are sufficiently tight that this may not even be possible.

However, we believe that there is a need to ensure that AEMO undertakes a clear and genuine consultation process with stakeholders on the forecasting inputs and assumptions. As such, we contend that this should be a requirement imposed within the Rules and that the AER should be able to reject a T-3 or T-1 instrument request on the grounds that AEMO's consultation process was determined to be insufficient.

We note that Section 4A.B.5 sets out what the AER's Forecasting Best Practice Guidelines must contain, which includes that "stakeholders should have as much opportunity to engage as is practicable, through effective consultation and access to documents and information".

Noting that Section 4A.C.11 establishes the criteria under which the AER may reject a reliability instrument request, we consider that a subclause should be added to this section along the lines of:

> "*AEMO's consultation process on forecasting inputs, assumptions and methodology meets the criteria set out in the AER's Forecasting Best Practice Guidelines*."

The Forecasting Best Practice Guidelines would then set out what is expected of AEMO's consultation process. We believe these changes would enhance the overall process of declaring a reliability gap and ensure that stakeholders have had a reasonable opportunity to critique and provide input to AEMO's forecasting process. This would also ensure that stakeholders have confidence in the process which determines that a T-3 or T-1 instrument request is sound.

Interaction of MTPASA and the ESOO

AEMO's decision to request a reliability gap period, and the MW and timeframes of a gap period, is proposed to be based solely on the results of the ESOO process. ERM Power is concerned that due to the timing of data inputs to the ESOO process, more up-to-date information could be ignored. This is particularly relevant for a T-1 period. Specifically, we consider that the Medium Term Projected Assessment of System Adequacy (MTPASA) should be used to confirm a gap period and that if MTPASA shows that the reliability standard will be met for the one-in-two year forecast then AEMO should be unable to request a T-1 instrument.

The MTPASA provides a weekly update of the expected supply-demand balance for the next 24 months and as such provides the most up-to-date indication of the likelihood and magnitude of forecast unserved energy in each half hour. This is based on the availability that Registered Participants have offered, the expected demand estimated by AEMO, intermittent generation forecasts and estimated transmission constraints. It represents a more granular and up-to-date forecast than the ESOO and as such would be an appropriate 'sense-check' for the ESOO prior to AEMO's request for a T-1 instrument.

Opt-in provisions

ERM Power appreciates the challenges the ESB has faced in determining the best way to allow customers to opt-in if they so wish. Issues of timing and thresholds are incredibly challenging to get right and we commend the work the ESB has done to try to design a system that is fair and reasonable for users and retailers.

We believe that the ESB has made a sensible decision to set the opt-in date at T-18 months. This provides retailers with ample opportunity to hedge a customer's load once it is clear whether the customer will be opting in or not.

We remain concerned however, that the opt-in rules provide scope for some large users to exploit a loophole and transfer risks to retailers. The decision to opt-in is likely to be attractive to a small minority of sophisticated users and therefore the risk of arbitrage is real and large. Some large users will have multiple connection points at a site for redundancy purposes and are able to move large blocks of load from one to another with minimal disruption to business. In theory, based on the draft rules, these large users would be able to opt-in at one connection point and then simply move their demand to a second connection point which remains the retailer's demand to manage. This creates a situation where a retailer is unable to hedge the user's load in advance and there is no added benefit to the system through lower demand at a time of critical demand as it is simply transferred from one connection point to another. To avoid this situation, ERM Power proposes that customers should be required to opt-in (if they choose to) for all sites in a node (i.e. state). This would avoid the risks we have outlined but allow for large users to opt-in if they choose to do so.

In a similar fashion, we believe that the prescribed opt-in arrangements should require the entire site to be opted-in with the two (or more) partners coming to a commercial arrangement between themselves for how to split the obligation between themselves. An arrangement which allows a partial volume of the load to be opted in with the balance remaining with a retailer adds significantly to the complexity and risk of managing the obligation.

Demand response contracts

ERM Power believes the proposed approach to demand response contracts may lead to unintended consequences that could either expose retailers to additional risks or hamper the further growth of demand response. The draft rules must ensure that liable entities are not placed at risk of non-compliance as a result of third-party aggregators selling demand response aggregated across a number of retailers' loads and liable entities facing an upwards adjustment to their adjusted actual demand values. Retailers will likely have no control or visibility of the dispatch of demand response via a third-party aggregator. Such that third parties are able to register demand response arrangements as a qualifying contract under the RRO, this should only occur with the consent of the impacted retailers. Liable entities whose load is affected by the third-party arrangement should also not face an increase to the adjusted actual demand if they are not using the demand response as a qualifying contract.

Procurer of Last Resort cost recovery

ERM Power appreciates the extent of the ESB's descriptions of how costs for the Procurer of Last Resort (PoLR) Mechanism will be recovered. This provides a helpful indication of what liable entities can expect should the PoLR mechanism be necessary.

The ESB asks a series of questions around the implications of passing on PoLR costs. We consider that the retail market will determine how costs can be refunded or passed on to consumers as necessary. There are a multitude of possibilities that could arise due to splitting costs between the Reliability and Emergency Reserve Trader (RERT) and the PoLR, the impact of customers opting-in to manage their own liability and the fact that PoLR costs are only determined 30 weeks after the gap period has ended.

It will be incredibly challenging for the ESB to design arrangements that can cater to all possible eventualities. We firmly believe that competition in the retail market will reward retailers who find appropriate ways to refund customers if refunds are due, and punish non-complying retailers who unfairly pass on PoLR costs. This is acutely true in the C&I market where contracting is between sophisticated parties with detailed contract terms.

Finally, we do not consider that the ability to pass on PoLR costs to C&I users reduces the incentive for retailers to contract to their peak demand forecast at T-1 under the RRO as raised in the consultation paper. A retailer would be subject to additional penalties from the AER for non-compliance and would likely find it difficult to attract customers in the future if it displayed a pattern of non-compliance, particularly if customers were concerned that a non-complying retailer was unfairly passing PoLR costs through.

Actual demand vs adjusted actual demand

The draft rules introduce the concept of 'actual demand' as part of the RRO which we believe is misleading and likely to lead to confusion. The definition of 'actual demand' as per clause 4A.A.4(b) includes adjustments to increase demand for events that may otherwise have led to increased demand. ERM Power believes that it is problematic to define actual demand as something which is adjusted. AEMO already publishes actual demand in real time as per subclause 3.13.4(x) of the National Electricity Rules.

We consider that it would be far clearer to retitle this clause as 'adjusted actual demand'. This would be consistent with the use of terms like 'highest adjusted peak demand' which is used elsewhere in the draft rules, for example in clause 4A.F.3.

This definition would then need to follow through elsewhere in the draft rules including clause 4A.B.3(b)(1) which would set out "the methodology for determining the adjusted actual demand for a trading interval".[2]

[2] Text in red represents our proposed changes to the draft rules.

Furthermore, we believe that there is no case for this clause to allow for demand to be adjusted for something as opaque as “any other adjustments as set out in the Reliability Forecast Guidelines“. We understand the reasoning to adjust demand for issues such as AEMO Directions, the volume of RERT dispatched and any AEMO-instructed load-shedding, but we fail to see how other issues, which could be based on a subjective assessment, are relevant in these calculations. ERM Power therefore recommends that subclause 4A.A.4(b)(2)(iv) be deleted.

Definition of the reliability gap

The stakeholder forum in March indicated that a reliability gap would be present if there was a breach of the reliability standard against the one-in-two year peak demand forecast. ERM Power is pleased that the ESB has recognised the importance of the reliability standard as a robust and well-understood metric that balances the costs and benefits of maintaining reliability close to 100 per cent.

However, the draft rules are unclear about this. We believe that the rules should explicitly include this information. This change can be made very easily by amending clause 4A.B.2 to read:

> ***4A.B.2 Reliability forecast components***
>
> *A reliability forecast and indicative reliability forecast for a region for each financial year must include the following:*
>
> > *(a) AEMO’s unserved energy forecast based on the one-in-two year peak demand forecast for a region and whether or not there is a forecast reliability gap;*

If this change is not made, it leaves the possibility of a gap period being declared due to projection of unserved energy based on higher demand forecasts such as a one-in-ten year peak demand forecast.

Draft clause 4A.B.4(b)(6)(iii) appears to support our proposal this as it refers to “explanatory material about how demand forecasts (including the one-in-two year peak demand forecast) are calculated and produced” rather than just how the one-in-two year forecast is calculated. ERM Power considers it is essential that the rules provide clarity that it is the one-in-two year peak demand forecast that determines whether a reliability gap exists or not.