



COAG
Energy Council

ENERGY SECURITY BOARD Retailer Reliability Obligation

Firmness principles for
qualifying contracts
December 2018

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1. Introduction

At the 26 October 2018 COAG Energy Council meeting, Ministers requested the Energy Security Board (ESB) progress development of draft National Electricity Law (NEL) amendments that would give effect to the Retailer Reliability Obligation (the Obligation). The ESB will return to Council with a final draft Bill for decision in December 2018.

The final detailed design for the Obligation was published in August 2018, along with exposure draft legislation, for consultation.

This consultation paper is part of a package focused on some more detailed policy issues relating to the Obligation. Other issues on which the ESB is seeking feedback include the materiality of the reliability gap and the compliance and cost-recovery regime. The ESB has also undertaken consultation on the introduction of a market liquidity obligation as part of the Obligation. Feedback will inform development of the content of the content of the detailed Rules which will implement the majority of the technical detail of the Obligation.

The ESB intends to release exposure draft rules for stakeholder feedback in early 2019 and present a final package to Ministers early in the second quarter of 2019. The intention is that the Obligation will commence on 1 July 2019, subject to agreement by the Council at its December 2018 meeting.

2. Background

2.1 Purpose of this paper

This paper proposes a framework for developing a methodology for the treatment and firmness adjustment of various types of contracts under the Obligation. The paper outlines a process where liable entities will be able to seek certification of their methodology for calculating their net contract position from the AER ahead of the Obligation being triggered.

The paper also seeks stakeholder views on key elements of the proposed firmness adjustment framework, while providing an outline of the broad treatment expected with common types of contracts utilised by participants.

2.2 Proposed framework for firmness adjustment

The final detailed design provides that if the obligation is triggered, liable entities will be required to enter into sufficient qualifying contracts to cover their share of a one-in-two year system peak demand at the time of the reliability gap to meet possible future compliance.

If a material gap persists one year from the forecast reliability gap (T-1), liable entities would be required to submit their 'audited' net contract position to the AER, ensuring the net position has been appropriately adjusted for the 'firmness' of contracts used for compliance.

- It is proposed that the National Electricity Rules will set high-level principles for the development of a firmness adjustment methodology, while providing the authority to the AER to develop a more detailed guideline to assist liable entities in developing their individual methodologies.
- Prior to T-1 (one year before a forecast reliability gap), liable entities will submit their methodology for calculating their net contract position to the AER for approval.

- If a material gap persists at T-1 and the reliability obligation is triggered, liable entities will calculate and submit their net position in MWs to the AER for the period of the gap in the relevant region.
- Liable entities would be responsible for considering, and appropriately adjusting for, the firmness of contracts used for compliance. An appropriately qualified independent auditor, appointed by the liable entity, would certify the calculation adhered to the methodology approved by the AER.
- The firmness of qualifying contracts used for compliance will be approximated by a “firmness factor” between 0 and 1 for each qualifying contract.
- The firmness factor of each contract should account for the degree to which the qualifying contract reduces the entity’s exposure to high spot prices in the region of the gap, during the period of the reliability gap.

For example, a swap contract with fixed volume could be considered fully firm. However, a swap with volume linked to a variable component, such as plant availability, would be less firm with a factor lower than 1. Similarly, a power purchase agreement (PPA) for the purchase of a generator’s output would have to account for how effectively the output from the underlying physical asset could be relied upon during the period of a reliability gap. Where there are no other hedging arrangements in place, this would result in a factor lower than 1. If the PPA was backed with a firming product, this could increase the firmness and result in a factor of 1 (up to the limit of the coverage provided by the firming product).

The firmness of cap contracts will vary, as a cap contract with a strike price of \$300/MWh could be considered fully firm with a factor of 1. However, if a cap has a strike price close to the market price cap (MPC), it would be considered non-firm as the seller has less incentive to defend the contract. This could be thought of as a sliding scale of firmness between lower strike price caps (e.g. \$300/MWh with a factor of 1) and caps at the MPC (currently \$14,500/MWh with a factor of 0).

3. Principles for firmness adjustment of qualifying contracts

3.1 Key Factors for firmness adjustment

The ESB is proposing the following four factors be considered as high-level principles set in the Rules for the determination of firmness of qualifying contracts:

1. The strike price of the contract;
2. The variability and profile of the volume settled under the contract;
3. The likelihood of the contract providing cover to the buyer during the reliability gap; and
4. Any other contractual terms which limit the coverage or otherwise reduce the incentive for a seller to “defend” the position.

Additional material developed by the AER in its guideline would expand on the above principles, providing more guidance on the treatment of various financial products and possible variations in firmness that may be observed between regions.

The individual methodologies developed by liable entities may be similar to the approach which a liable entity currently applies to determine its positions for risk and/or financial reporting purposes.

Detailed historical or forward-looking analysis may be required to support the entity's determination of how the key factors affect the firmness of the relevant contract. The depth of analysis would need to be sufficient to satisfy the AER that the methodology applied to determine the firmness factor is robust and reflects a satisfactory degree of confidence.

The strike price of the contract

The firmness of a qualifying contract should account for the degree to which the strike price of the contract decreases the seller's exposure to high spot prices. The closer the strike price of the contract is to the market price cap, the lower its effectiveness in mitigating exposure to high prices. The lower the strike price of a contract, the higher the incentive for the seller to bid strategically and make itself available to defend the contract during a reliability gap, which increases the reliability of the system.

The variability and profile of volume settled under the contract

The firmness of a qualifying contract should account for the degree to which the volume of the contract can be relied upon to provide hedge cover to the buyer during the reliability gap. The capacity associated with contracts varies between products. For example, a flat or peak futures contract or OTC swap that has volume under contract either fixed or dependent on the buyer's load profile would be firmer than a swap or cap whose volume was dependent on a plant's output (e.g. PPA). The less variable the volume associated with a contract, the more it can be relied upon to support the system during the period of a reliability gap.

The likelihood of the contract providing cover to the buyer during the reliability gap

The firmness of a qualifying contract should account for the probability and expected duration of cover provided to the buyer during the reliability gap. Certain financial products apply for specified time periods, such as a quarterly baseload future or OTC swaps, which provides a fixed price for electricity 24 hours a day, seven days a week for the quarter purchased. However, other financial products may apply only for a certain period, have limits on payouts, or be triggered by a specific event (e.g. a \$300 cap product that was triggered by low wind output – this may be offered by a dispatchable gas fired generator as it is more likely to match its operating profile than a flat 'vanilla' contract). These features will affect the overall firmness of the contract, provided the contract decreases exposure to high spot prices over the period of the reliability gap.

Other contractual terms

The firmness of a qualifying contract should account for any other key contractual terms of the contract which limit the cover provided to the buyer during the reliability gap.

Questions

- Are there any principles that should be added or removed from this high-level list?
- What level of detail would liable entities consider necessary to support the principles?

4. Compliance framework

4.1 AER guideline

The AER will develop a guideline to assist liable entities in determining the appropriate treatment of various types of financial instruments. The guideline is not intended to provide an exhaustive, or prescriptive list of treatments for each individual type of bespoke financial product, so as not to restrict the development of new and innovative products by participants to manage price and volume risk. This will be particularly important as the share of variable renewable generation increases in the NEM.

The purpose of the AER guideline is to provide liable entities a reasonable level of confidence as to how the AER will approach the assessment of their methodologies when submitted for approval and will therefore be broad in nature.

It is expected the guideline would be reviewed on a regular basis (e.g. every two years) to account for changing market conditions or the increased use of new, bespoke hedging products.

The AER guideline will outline the processes for liable entities to follow in terms of the timelines associated with submitting their net contract position to the AER at T-1, as well as dispute resolution processes.

4.2 Firmness methodology

To improve the transparency of the compliance process and decrease the uncertainty some liable entities may face while developing their firmness methodologies, the ESB is proposing a process where liable entities will seek approval of their methodology from the AER prior to the submission of their contract positions at T-1 (but following the triggering of the obligation at T-3).

This would allow liable entities to consult with the AER on the development of firmness measurement methodologies whilst also ensuring that it aligns with their organisation's internal risk management processes. Liable entities would seek to have their methodology approved in the period between T-3 and T-1, with a view that the methodology must be approved prior to the AER calling for contract positions at T-1 (if a material gap persists). Methodologies would need to be updated in the event the AER published a new guideline that represented a significant departure from the treatment of products from the previous guideline, or if a liable entity started relying heavily on a new type of financial product that was unaccounted for in their previously approved methodology. This approach would see methodologies essentially updated on a needs-basis and prevent a rolling or continuous and onerous process of seeking re-approval.

By seeking prior approval of a firmness methodology from the AER, liable entities will have increased confidence when finalising and calculating their contract position ahead of T-1.

4.3 Compliance

At T-1, the liable entity will supply a report and the relevant supporting data to the AER which includes their firmness adjusted net position for all trading intervals during the period of the reliability gap.

Prior to the submission of a net contract position to the AER, liable entities will need to appoint a suitability qualified independent auditor to prepare an audit report declaring the net contract position submitted to the AER was determined in accordance with the previously approved methodology. This report must be submitted along with the net contract position to the AER. The report will also need to be signed by the authorised signatory of the relevant entity.

The liable entity may have to seek a re-audit if it wishes to amend any of the methodologies used to determine firmness or becomes a party to different qualifying contracts. This would need to occur prior to T-1, and methodologies for the adjustment of firmness would not be accepted between T-1 and T.

Following the period of the reliability gap, if peak demand exceeds the one in two-year threshold, the AER will assess the contract positions submitted by liable entities and confirm if the level of contract coverage was sufficient to meet their obligation. During this period, the AER may request additional supporting information from liable entities to ensure their net contract position was calculated using agreed methodologies.

Questions

- Are participants comfortable with the approach proposed by the ESB, with high-level principles for the adjustment of firmness to be included in the Rules, and the AER providing additional information for liable entities through the development of a guideline?
- Do stakeholders consider the ESB's proposal for liable entities seeking approval of their firmness methodology from the AER prior to T-1 decreases uncertainty and provides an appropriate level of transparency for compliance with the obligation?

5. Consultation timetable

The ESB invites comments from interested parties on the issues and questions set out in this paper by **21 December 2018**. Feedback received will inform the ESB's advice to the COAG Energy Council on implementation options.

Submission close date	21 December 2018
Lodgement details	Email to: info@esb.org.au
Naming of submission document	[Company name] Response to Firmness Principles for Qualifying Contracts.
Late submissions	Late submissions will not be accepted.
Publications	Submissions will be published on the COAG Energy Council's website, following a review for claims of confidentiality.

Contact details:
Energy Security Board
E: info@esb.org.au
W: <http://www.coagenergycouncil.gov.au/energy-security-board>