

RWE Supply & Trading Submission

National Energy Guarantee, Draft Detailed Design Consultation Paper: 15 June 2018

1 Summary and Overview

RWE Supply & Trading GmbH (RWEST) very much welcomes the opportunity to contribute once again to the consultation on the design of the National Energy Guarantee (NEG). RWEST is one of Europe's largest traders of power, gas, emissions and related commodities on a global scale. We act as a significant provider of liquidity and market maker across Europe's interconnected power, gas and emissions wholesale markets. RWEST is part of the RWE Group which is a leading pan-European energy company with over 40 GW of installed capacity in Germany, the UK and the Netherlands. We entered the Australian wholesale market in 2013 and are an active participant on the Australian Securities Exchange (ASX). This submission continues our earlier consultation response and draws on our experiences in the Australian wholesale market coupled with our knowledge and experience of power and emissions market design and trading in Europe and North America. As many points still need to be worked out in a detailed technical working paper, we offer our continuous support and expertise for the development of the Technical Working Paper on the Emissions Registry and look forward to working with the Energy Security Board (ESB) in this regard.

RWEST appreciates the establishment of an emissions registry within the **emissions reduction requirement** which is welcomed and necessary to allow Australia to meet its emissions reduction targets. Despite the decoupling of the underlying physical electricity transaction from the associated emissions through the use of the emissions registry, we remain concerned that the proposed mechanism may still undermine liquidity and efficiency of the current electricity market for reasons stated in our earlier response and as briefly summarised in this submission paper.

We urge the ESB to further investigate whether a more ambitious approach can be taken towards the separation of the electricity transaction and associated emissions, and whether this can be allowed in an even more transparent fashion. Under the proposed mechanism, no direct link will be required between the electricity transaction and the respective emissions. However, by not making the emissions component its own product (by effectively installing an emissions certification trading regime) the risk remains that in practice, emissions will be tied to the electricity transactions through the use of bilateral power purchase agreements (PPAs). Such practice would undermine wholesale market liquidity and lead to sub-optimal investment, reduced retail competition and greater scope for the exercise of market power.

With regards to the **reliability requirement**, we are concerned that the obligation is placed on the most vulnerable market players. Retailers have limited security over their future customer portfolios and few, if any, tangible assets that would be required for collateralisation of long-term, multi-year capacity contracts. The cost of credit would again hinder competition, act as a significant barrier to entry for new retailers, could reinforce a need for vertical integration and ultimately lead to higher costs for Australian consumers. Furthermore, the risk of deliberate non-compliance

through the introduction of the default “provider of last resort” and the strong incentive to under-procure for retailers are further risks in the proposed reliability requirement.

Instead, a separate and centrally-procured reliability requirement should be introduced under which the operator should purchase MW capacity from generators in the form of reliability options. As noted in our earlier statement, reliability options could be purchased with a lead time (of one to four years) with the option for an additional top-up procurement if required. The procurement costs would be reimbursed by retailers in accordance with their contribution to total peak load. The volume of options sold by generators would be scaled explicitly (or implicitly) to the ability to dispatch that capacity to provide “firm” capacity.

Again, we would like to point out that the review should be extended to the **gas market** as a transparent and liquid physical and financial gas market would significantly increase the scope for contracting and investment in the power sector by allowing generators to better manage the spread between gas and power prices. This would also provide signals for investments in gas as well as power assets which will become of even more importance in the future as the decarbonisation is likely to increase electricity demand overall, thus requiring more flexible generation technologies (such as power-to-gas).

2 Emissions Requirement

RWEST welcomes the necessary establishment of an emissions registry. However, despite the decoupling of the underlying physical electricity transaction from the associated emissions through the use of the emissions registry, we remain concerned that the proposed mechanism may still undermine liquidity and efficiency of the electricity market.

While not required under the proposed scheme, we are concerned that emissions will, in practice, be attributed under PPAs or – at least – between the same counterparties of a PPA in order for market customers to effectively plan compliance with the emissions requirement. This will undermine the efficiency of the physical market as plants respond to the incentives provided under the contract rather than efficient spot market price signals. The result can be inefficient maintenance, availability, scheduling and dispatch decisions. A lack of fungibility in the physical market also threatens to destroy liquidity in the financial hedging market. Reduced liquidity will further undermine competition by removing efficient forward market signals for investment, maintenance and unit commitments.

Furthermore, the introduction of this mechanism could make it harder for investors and new entrants to enter the retail markets. This holds true in particular for those market parties that trade primarily on the ASX with limited direct access to generators holding emission rights. These market parties would then be subject to the allocation of the higher residual emissions that have not been allocated during the compliance period. Consequently, we are concerned about the risks such practice would pose to competition and liquidity on electricity wholesale markets and the burden it places on retailers and larger industrials that purchase their electricity directly from the NEM. New market customers entering the NEM may find it significantly harder to compete with established market customers following the introduction of the emissions requirement. Such development

would also pose significant risk to the exertion of market power to the detriment of smaller generators and retailers.

Consequently, we urge the ESB to further investigate whether a more ambitious approach can be taken towards the separation of the electricity transaction and associated emissions, and whether this can be allowed in an even more transparent fashion. Please see our earlier response and the proposal to introduce standardised “Emissions Requirement Contracts” that would address these concerns.

3 Reliability Requirement

Once again, we would like to highlight fundamental doubts about the practicality of a reliability requirement placed on retailers that is backed up by a central procurer of last resort. The administrative burdens imposed on AER and AEMO seem unduly excessive and the risk that retailers are unable to effectively perform this requirement prevails. Instead, a centralised option should be installed under which costs are shared and contributions to system stability are rewarded to give proper investment incentives and signals.

Specifically, we continue to believe that an approach based on signalling a future need to retailers coupled with an expectation of action will not be sufficient for the retailers to procure the required capacity. As noted in our earlier response, there remain a number of reasons why these requirements on retailers and larger industrials will prove unworkable. Most importantly, we want to highlight again that retailers have limited security over their future customer portfolios and few, if any, tangible assets which would be required for collateralisation of long-term, multi-year capacity contracts. The cost of credit would again hinder retail competition, act as a significant barrier to entry for new retailers, could reinforce a need for vertical integration and/or restrict electricity retail to companies with strong balance sheets and ultimately lead to higher costs for Australian consumers.

Furthermore, the risk of deliberate non-compliance through the introduction of the default “procurer of last resort” and the strong incentive for retailers to under-procure create further risks for the proposed reliability requirement. Retailers will have to bear the cost of collateral, procure capacity they may not need and generally run tight portfolios. Instead, relying on the centralised procurement will see retailers pay the actual capacity required (plus a fee).

We note the proposal of a **Market Liquidity Obligation** which we appreciate. If introduced, it is of importance that new products are designed to fulfil the reliability requirement. The experience with the mandatory market making requirement under the Secure and Promote License Condition as introduced by Ofgem in the UK, has shown that an existing market has effectively split into two separate daily trading windows, outside of which almost no trades are possible in the UK forward electricity market. We therefore note that the design of such a market must result in sufficient liquidity available for spreads to be narrow. As a well-established market place, we suggest that the ASX be used as a central and transparent platform for market parties to fulfil the obligation.

However, we once again would like to highlight that:

- The reliability requirement should be introduced as an ongoing obligation from the outset rather than incorporating various stages and triggers which all need to be independently reviewed and are subject to further scrutiny from market participants.
- Appropriate scarcity pricing – as practised in the NEM – can be sufficient to ensure that capacity is brought forward by generators in response to the prospect of future price spikes.
- Mixing up financial hedge contracts and physical capacity contracts as qualifying contracts seems unworkable as someone, even if it is the financial counterparty holding the risk, will need to procure the physical capacity – likely to be the “procurer of last resort”.
- Introducing a firmness factor that lacks further detailed specifications and which will be subject to an independent auditor’s report further increases the burden placed on retailers. We are of the opinion that, if introduced, there needs to be a clear firmness assessment of qualifying contracts.

To conclude, we again recommend the introduction of a reliability requirement backed by the centralised procurement of capacity. The requirement could be met via the annual and centralised procurement of “reliability options” at a forward horizon of up to four years together with an annual “top up” procurement for the following year if required. The annual costs of meeting this requirement would then be charged to retailers and large customers according to their peak load during the year and generators would receive an upfront option payment in return for forgoing some of the benefits of very high prices at future peak. As noted in our earlier response, reliability options would place the reliability requirement with the correct market players (generators) and provide strong incentives for generators to remain available at times of scarcity as they face a price exposure above the strike price up to the value of lost load if they are not available.
