

ENERGY SECURITY BOARD
National Energy Guarantee
TECHNICAL WORKING PAPER

**Compliance and Penalties for the
Reliability Requirement**

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Executive Summary

- AEMO will report a 'material' gap in reliability at T-3 and the AER will need to approve a request from AEMO to trigger the reliability obligation. This provides a signal to liable entities that they may be expected to demonstrate future compliance.
- If a material gap persists at T-1, the AER will request liable entities to submit their contract positions.
- If there is a material increase in contracted Commercial and Industrial (C&I) load below the 5 MW threshold between T-1 and T a liable entity may apply to the AER for a variation of its T-1 contract position.
- A liable entity's peak demand is determined as its actual share of peak demand at time T 'scaled' to the one-in-two year peak demand forecast (at T-1) level where the actual regional demand is greater than the forecast demand. This is the safe-harbour design element that only requires liable entities to meet the one-in-two year peak demand forecast (at T-1).
- The AER will assess compliance for each trading interval in which actual demand exceeds the one-in-two year peak demand forecast at T-1.
- A liable entity found to be non-compliant will be charged a predetermined proportionate cost – based on its MW contribution to the shortfall multiplied by a contribution cost per MW - to contribute to the cost incurred by consumers as a result of the Procurer of Last Resort costs.
- In addition to the Procurer of Last Resort contribution cost, non-compliance with the core reliability obligation will be a civil penalty provision. Further civil penalties will also be attached to key obligations such as contract reporting.

1 Introduction

On 20 April 2018, the Energy Security Board (ESB) presented the COAG Energy Council with a high-level design proposal for the National Energy Guarantee (the Guarantee). The COAG Energy Council agreed that the ESB progress the detailed design of the Guarantee for determination by the Council at its August 2018 meeting.

As part of the development process, the ESB convened Technical Working Groups to advise on certain detailed design elements of the Guarantee. The Technical Working Groups were comprised of a broad range of stakeholders with relevant expertise from more than 30 organisations.

The purpose of this paper is to outline options and preferred approaches relating to compliance and penalties for the reliability requirement under the Guarantee, in particular:

- what the compliance obligation is for reliability (the reliability obligation)
- how the compliance obligation is determined
- the cost allocation mechanism for Procurer of Last Resort costs, and
- the penalty regime for non-compliance.

These detailed design issues were considered by the Compliance and Penalties Technical Working Group.

This paper provides additional detail and context to the [Draft Detailed Design Consultation Paper](#). Interested parties are encouraged to lodge a submission to the consultation by **13 July 2018** for consideration by the ESB prior to the publication of the final design of the Guarantee.

2 Overview of High-Level Design

The Australian Energy Regulator (AER) will be the enforcement agency for the reliability requirements of the Guarantee. The reliability requirement framework will operate as follows:

- If AEMO identifies a 'material' gap in capacity three years into the future, it will make a request to 'trigger' the reliability obligation. An independent entity (the AER, see Technical Working Paper on Forecasting the Reliability Requirement) reviews AEMO's request and approves it if it is consistent with the assessment framework set out in the Rules and reasonable, based on all information available.
- If a material gap in capacity persists one year ahead, the AER will notify liable entities (retailers and large customers) that they will be required to submit their contract position to the AER, demonstrating that they have sufficient enduring contracted capacity (including demand response) over the gap period to cover their share of a system peak demand event which would be expected to occur every one-in-two years. Concurrently, AEMO will also commence procuring capacity to fill the gap as the 'Procurer of Last Resort'.
- The expected one-in-two year peak demand event will be forecast ahead of time, while the obligations of liable entities will be based on observed demand at the peak period.
- After the peak demand event (and only if peak demand actually exceeded the one-in-two year peak demand forecast threshold), the AER will assess whether liable entities submitted adequate contracts to cover their obligation.
- Costs will be assigned to liable entities who fall short of their obligation.
- Where all liable entities meet their obligations or peak demand does not exceed the one-in-two year peak demand threshold, the costs of the Procurer of Last Resort function will be socialised to consumers in the relevant region, as per the existing design for the RERT. The AER has discretion to administer further financial penalties for non-compliance. The AER will also retain its usual suite of enforcement options in the event of more significant or repeated failures to comply occur.

The compliance framework and penalty regime are inherently dependent on the broader design of the Guarantee. As such, the proposed approach to compliance and penalties will evolve as the detailed design of other elements of the Guarantee is settled. Decisions on other design elements will take into account the ability to monitor and enforce compliance.

There are a number of elements relating to the compliance framework that are discussed in other working group papers. Whilst not discussed in this paper, these elements are relevant to the overall design of the compliance framework. In particular, the following Technical Working papers:

- Forecasting the Reliability Requirement
- Liable Entities
- Qualifying Contracts
- Demand Response

Guiding principles

The approach to compliance and penalties has been developed with reference to the following guiding principles:

1. The obligations should be fair and consistently applied to all liable entities.
2. The framework should be appropriately transparent in respect to; AER activities, information requirements for liable entities and third parties, along with the AER's compliance assessments.
3. The information requirements must be standardised and appropriate to meet the compliance requirements.
4. The compliance costs should be minimised where possible.
5. Any penalties will need to be sufficient to encourage compliance.

3 Defining compliance with the reliability obligation

If the market has not responded sufficiently to the triggering of the scheme three years ahead (T-3) and there remains a material gap at one year ahead (T-1), liable entities must be in a position to demonstrate (if required) compliance through qualifying contracts. A liable entity achieves its reliability obligation when it can demonstrate, one year ahead (T-1) of a forecast 'material gap', that it had procured sufficient eligible contracts to meet its share of system peak demand during the period of the expected gap (T) in the specified NEM region.

The compliance obligation, arises when the reliability obligation remains in place at T-1 and the one-in-two-year system peak demand forecast (that liable entities were expected to contract for) was exceeded.

Outlined below is further detail on the compliance assessment including how to measure and define:

- regional demand
- one-in-two year peak demand forecast
- how the compliance obligation is activated
- a liable entity's actual demand
- the compliance obligation, and
- the high demand intervals that will be assessed.

3.1 What are the key parameters that trigger a compliance assessment?

A liable entity would only be required to demonstrate its compliance with its reliability obligation if the following two conditions have been met:

1. The reliability requirement has been triggered three years out due to a forecast material gap, and a material gap persists one year out, and
2. The actual demand in the relevant region exceeds the one-in-two year peak demand forecast during the period for which the reliability gap has been identified.

Determining regional demand

The demand in each region is measured and reported by AEMO every 5 minutes. AEMO use a number of different demand measures for various purposes ([see AEMO Demand terms in EMMS data model](#)). For the purpose of compliance assessment, an appropriate demand measure will be used as the trigger to assess compliance when it exceeds the one-in-two year peak forecast demand. One option for actual system demand is operational demand as it is likely to provide the best measure, however a new demand measure may be required to ensure the demand measure is fit for purpose.¹

¹ The earliest that the reliability requirement could plausibly create obligations is summer 2022-23, assuming implementation in 2019 and a minimum three year notice period. By this stage the five minute settlement rule change will have taken effect. So the relevant trading interval consideration for the reliability requirement is five minutes.

Preferred approach

- When assessing compliance, the system demand used for calculations will be AEMO's published trading interval operational demand.

What is the one-in-two year peak demand forecast?

AEMO prepares regional peak demand forecasts that are published, along with the ES00 assessment, each year on 31 August. The demand forecasts include a number of "probability of exceedance" forecasts to indicate a range of possible outcomes. For the purpose of the reliability requirement component of the Guarantee, the demand forecast that will be used is the one-in-two year regional peak demand forecasts (neutral scenario), as these are considered to provide a good balance between being reasonably likely, and providing a reasonable level of confidence in the level of certainty.

The one-in-two year peak demand forecasts for each region are published each year by AEMO for the upcoming ten years. The demand forecasts published with the ES00 for the period three years into the future (T-3) is the first point at which AEMO is required to determine if a reliability gap exists. At the T-3 forecast, if AEMO determines that there is a material reliability gap, the independent reviewer will consider whether to trigger the reliability obligation.

Preferred approach

- When assessing compliance the one-in-two year peak demand forecast used for each region will be the forecast determined by AEMO in the ES00 at least one year in advance.

How will the compliance obligation be activated at T-1?

At T-3 if the AER, as the independent reviewer, decides to trigger the reliability obligation, it will advise the market and at this point, liable entities will be on notice that they may be required to provide their contract position to the AER at T-1.

From T-3 to T-1 AEMO will continue to update the regional demand forecasts, the supply forecasts and other relevant matters. These updates will be included in each ES00 update.

If a material reliability gap remains at time T-1, then liable entities will be advised by the AER that the compliance obligation is activated. This will mean that retailers will need to report their contract position for the reliability gap period. As outlined above liable entities will also be subject to a potential compliance assessment.

At this point in time, the regional one-in-two year demand forecast for the relevant region(s) will become a key input in any subsequent assessment of each liable entity's compliance.

If the reliability gap is no longer material at T-1, then the compliance obligation on liable entities will not arise.

How is a liable entity's demand measured?

Once the compliance obligation has been activated by the AER, the trigger to assess compliance is if the actual regional demand exceeds the T-1 one-in-two year peak demand forecast.

The measurement of each liable entity's share of demand is determined by reference to the metering and settlements data held by AEMO. This data is captured by metering service providers and provided to AEMO on a weekly basis. The data becomes "final" and settlement statements are issued after 20 business days. The metering and settlements data is then subject to two potential revisions, with revision one at 20 weeks and revision two at 30 weeks.

The compliance assessment needs to be carried out in a timely manner using the best available data. The liable entity's compliance will be carried out using the latest settlements data which is available after 20 business days and subject to revisions after 20 and 30 weeks.

Preferred approach

- When assessing compliance a liable entity's demand will be measured using settlements data which may take up to 30 weeks for the data to be finalised.

3.2 Compliance period under assessment

Once the AER has activated the compliance obligation, and where actual system demand exceeds the one-in-two year peak demand forecast, the AER will need to assess whether a liable entity has complied.

The scope of this compliance assessment will depend on a number of factors such as what high demand intervals are assessed and the granularity of this assessment.

With consideration of these factors, outlined below is when the compliance obligation will arise and how it is assessed

Defining the compliance obligation

The intention of the reliability obligation is for liable entities to have sufficient contracts in place to cover their share of system peak demand during a material reliability gap period. In practice, compliance will only be required to be demonstrated if the above mentioned two conditions are met.

The duration of the compliance obligation is an important parameter in determining how compliance is characterised and also assessed.

The compliance obligation is best characterised by a defined window of time in which demand has exceeded the threshold, such as a trading interval, day or week.

The compliance obligation should be defined in such a way as to allow the AER to appropriately assess actual demand and contracted positions of each liable entity without unduly simplifying complex and dynamic market movements. The key components of the assessment such as actual demand should therefore be appropriately accurate to allow the AER to assess as close to real time information as possible, as opposed to generalised information such as the calculation of daily averages of a liable entity's demand.

Key information such as actual demand, both for actual regional demand and settlement data, is calculated for each trading interval. Furthermore, contracts are predominantly settled with reference to the trading interval (spot) price. An accurate compliance assessment should therefore draw from these key figures to assess compliance.

The compliance obligation should also be appropriately focused to capture the contravening conduct. As discussed, a compliance assessment will need to occur when actual regional demand exceeds the one-in-two year peak demand threshold. There is no obligation for any time period when regional demand is less than this threshold.

The most targeted option is to assess compliance for each trading interval in which actual demand exceeds the one-in-two year peak demand forecast T-1 threshold.

How many high demand intervals should be assessed for compliance?

The reliability obligation is likely to occur over the annual peak demand period, which for most regions is summer. There may be multiple intervals (multiple trading intervals in a day and multiple days) across the relevant period where actual demand exceeds the one-in-two year peak demand forecast threshold. In this circumstance, the AER could assess all intervals or limit the compliance assessment to either only the highest demand interval, or alternatively, a selection of the intervals.

The assessment of the highest demand interval may be appropriate where the framework is primarily concerned with the circumstance in which the system has the tightest demand and supply balance during the relevant gap period. This assessment would therefore be focused on whether liable entities had complied with the reliability obligation for this highest demand interval.

Whilst this may be an important component of the reliability requirement, one of the primary purposes of this requirement is also to incentivise contracting for the annual peak demand period. An assessment of only the highest demand interval may undermine this objective.

An assessment of all the high demand intervals, would likely provide a stronger incentive for liable entities to sufficiently cover the annual peak demand period.

As set out in section 6, the causer contribution requirement should not necessarily stem directly from all compliance intervals in which an entity is non-compliant. A more targeted assessment of causer contribution could be limited to the greatest shortfall for a given trading interval or the average of a select number of non-compliant trading intervals.

In consideration of these factors, the preferred approach would be to assess all intervals in which demand exceeds the forecast threshold. This would preserve the ability of the AER to assess all circumstances of non-compliance and to then exercise its discretion when determining appropriate compliance and enforcement action.

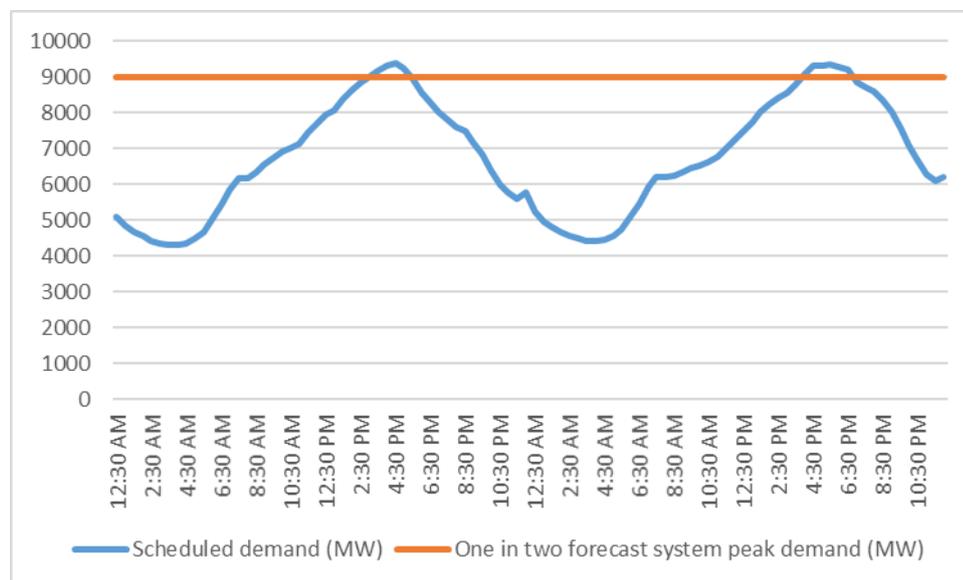
Preferred approach

- The AER will assess compliance for each trading interval in which actual regional operational demand exceeds the one-in-two year peak demand forecast.

Compliance obligation example

The chart below shows the actual demand for two days. Demand exceeds the forecast threshold on both days. On the first day for a continuous period from 3.30pm to 5pm and on the second day for a continuous period from 4pm to 6:30pm.

Figure 1: When compliance is assessed



In the proposed compliance approach, the compliance obligation would apply for each trading interval that falls within these two periods of time when demand exceeds the threshold. A finding of compliance, or non-compliance, with the reliability obligation would apply for each of these trading intervals.

4 Changes in contract position after T-1

In the event that compliance is assessed, the overall MW contract position reported at T-1 must have remained in place – that is their contract position is enduring (subject to potential changes as discussed in section 4.1). Whilst the liable entity may optimise its hedge book after T-1, the overall net position of agreed contracts must remain in place at all times to meet the compliance obligation.

4.1 Material change in circumstances after the contract reporting deadline

A key policy objective of this framework is to incentivise contracting more than one year in advance of a reliability gap. Whilst this requirement remains a central component of the

framework, there are circumstances in which liable entities are unable to prudently procure contracts at T-1 to meet their forecast customer load.

The *Technical Working Paper on Liable Entities* proposes a 5 MW threshold to define a liable entity. As outlined in that paper, there are many large C&I customers that fall below this obligation and as noted in that paper may be at risk of falling out of contract between T and T-1 and find it difficult to contract with a retailer. To manage the risk of these customers falling out of contract, there will be limited circumstances when changes to contract position will be considered when assessing compliance.

Where a liable entity can demonstrate that it had a material increase in forecast load between T-1 and T as a result of taking on a new large customer that falls below the 5 MW threshold, the liable entity may utilise any additional contracts acquired to comply with the reliability obligation for this assumed load.

In order for the additional eligible contracts to be considered, the liable entity must submit a notice to the AER outlining the change in circumstances and the additional load and eligible contracts that should be considered.

These exceptions will be managed on a case by case basis. The administrative task for retailers and the AER in accounting and applying for all less than 5 MW C&I customer variances could be significant. Therefore the following conditions must apply:

- A material change in circumstances would be limited to only if the retailer varies their committed customer load by some percentage (say, 1 per cent) as a result of taking on one or more new customers.
- The new customer must meet two conditions. It must be a large customer as defined in the NEL and Rules, and it must not a liable entity (i.e. it is below the 5 MW threshold). This provision will not be available for a change of load as a result of mass market customer load.

The AER will need to provide clear guidance on how this provision will apply to ensure market confidence in the process and a timely assessment of the contract variation.

Preferred approach

- If there is a material increase in contracted load between T-1 and T as a result of assuming one or more new large customer load (below a 5 MW threshold), less than one year before the gap period, a liable entity may apply to the AER for a variation of the T-1 contract position. This will be under limited circumstances only - the new customer(s) must be a large customer as defined in the NERL and NERR, and not a liable entity, and the combined new customer load for the liable entity must increase by more than a percentage, say 1 per cent. The percentage increase may be as a result of one or multiple customers.

4.2 Retailer of Last Resort

If a failed retailer causes a Retailer of Last Resort (ROLR) event between the T-1 and T period, a liable entity may be required, or agree, to assume a portion of the failed customer's load. If this were to occur the additional ROLR load would not be included in the compliance assessment.

The other option may be that any contracts the retailer had entered into prior to its folding are credited to the retailer that takes on the load, to give them an effective exemption from that portion of the load. The new retailer would still be expected to take steps to manage the balance of the load taken on through the ROLR process, with evidence of new contracts provided to the AER to demonstrate this at the point of ex-post compliance.

Preferred approach

- If a liable entity is allocated an additional ROLR load, this load will not be included in the compliance assessment.

5 Determining the contract requirement for the compliance interval

A key design consideration is how a liable entity's share of system demand is determined. As proposed in the High-Level Design Document, retailers are required to contract to cover their contribution to peak demand. As a safe harbour provision, the maximum level to which liable entities will be required to contract to is their share of actual regional peak demand that would be expected to occur one in every two years.

Therefore, when actual demand is above the one-in-two year expected peak demand (e.g. a one in ten year demand event occurs), retailer load will need to be 'scaled' down to a one-in-two year load level to determine contracting obligations. This will be achieved by assessing liable entities' contribution to peak demand, as a proportion of overall demand, and applying it to the pre-determined one-in-two year level.

As discussed in section 3.2, the AER will undertake a compliance assessment for each individual trading interval in which system demand was above the one-in-two year expected peak demand level. An entity's share of total regional demand is therefore required for each trading interval that is assessed. A key design question is how this will be determined.

As a key principle, the calculated share of system demand should reflect a liable entity's contribution to regional demand at that particular point in time.

With this principle in mind, calculations based on a weighted average across all trading intervals of an entity's load, in which demand exceeds the one-in-two year level, would not provide an accurate assessment of an entity's actual demand for a specific trading interval. This approach would 'smooth out' variation in demand calculations during potentially volatile periods.

Similarly, if the demand is calculated on a wider time period, such as the entire compliance period, or based on historic observations, then an entity's share of system demand would not reflect the entity's demand contribution for the compliance interval under assessment.

Therefore, the most appropriate option is to base a liable entity's share of regional demand on its actual demand during the compliance interval. The calculation would assess a liable entity's actual demand for each trading interval against actual system demand.

In turn, based on the share of actual demand, the entity's contract requirement to meet its demand will be 'scaled' to reflect their share of the one-in-two year system demand. That is a liable entity's' contract requirement is:

$$\frac{\textit{Entity's trading interval demand}}{\textit{Actual demand for the trading interval}} \times \textit{One in two year system demand}$$

In this calculation the one in two year system demand forecast will be based on the information available in the ES00. This calculation may be based on an hourly forecast of demand.

The treatment of demand response in the calculation of liable entities' market share and contracting obligations are discussed in the *Technical Working Paper on Demand Response* and the *Technical Working Paper on Qualifying Contracts*.

Preferred approach

- When assessing compliance a liable entity's share of regional demand will be based on their actual demand during the trading interval.

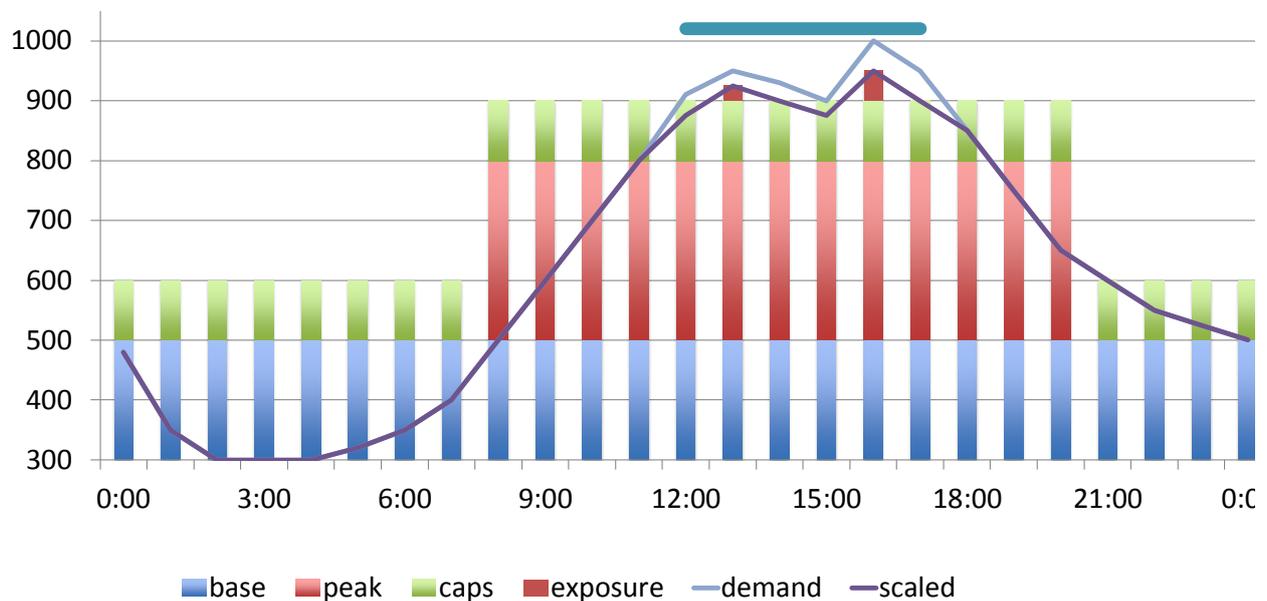
Determining contract requirement example

Figure 2 provides an illustrative example (showing hour long trading intervals for simplicity). The aqua line is the period (midday to 17:00) when the actual regional demand at time T is greater than the forecast at time (T-1) of the one-in-two year peak demand at time T. This is the period where the liable entity's demand – the light blue line – is measured and scaled down to the one in two year equivalent. So if the regional one in two year demand is 9,000 MW and the actual demand is 10,000 MW, the liable entity's demand is reduced by 10 per cent - the purple line. This calculation occurs for every trading interval (which in 2023 will be five minutes in duration) over the period of the aqua line. The liable entity's contract position is represented here simply as base swaps, peak swaps and caps (the blue, red and green columns). The liable entity has had the contracts externally audited and reported the equivalent 'firm' contracts for time T.

There are 2 trading intervals, 13:00 and 16:00 (the dark red column) where scaled demand is greater than the contract position and the liable entity is non-compliant.

If there are multiple days across the relevant reliability gap period where actual demand exceeds the one in two year demand forecast threshold, this assessment will occur for every day.

Figure 2: Outline of compliance assessment for the reliability requirement



6 Procurer of Last Resort – cost contribution by non-compliant liability entities

If the AER determines that a liable entity has not met the reliability obligation, then the entity must pay a contribution to the Procurer of Last Resort costs. It will be an automatic process where AER has no discretion in applying this cost allocation.

Procurer of Last Resort cost contribution

In the event that the AER determines a liable entity has failed to meet its contracting requirement, this shortfall must be translated into a cost liability to offset the Procurer of Last Resort costs that are socialised across all customers in a region by AEMO.

Due to the timing of the compliance assessment findings, which will be finalised well after the reliability gap period, the costs associated with the Procurer of Last Resort function cannot be offset by a payment from non-compliant entities before the residual cost is socialised by AEMO.

The cost contribution will therefore need to offset the Procurer of Last Resort costs in another form. This may be a direct socialised payment to all the market customers that initially funded the procurement, or a direct offset of any future RERT costs. AEMO currently applies charges to market customers for a number of functions such as ancillary services and system restart services. The payment could therefore reduce future AEMO charges to market customers in the region where the Procurer of Last Resort costs accrued. This has the same effect as reducing the Procurer of Last Resort costs, but it is delayed.

The quantum of the payment should be proportional to the contribution by the liability entity to the need for the Procurer of Last Resort. There are a number of ways to assess this contribution, which should have a component related to MW quantity contribution and a component related to cost per MW.

The following example outlines some options for determining the MW contribution.

The shape of future daily demand and supply are likely to be significantly different to that of today with both technology and demand change, it is preferred that the AER consult with stakeholders on the precise shortfall estimation approach in a period closer to a T-1 period where both the nature of the gap and other market conditions are clearer.

Preferred approach

- The detailed process for determining the assessment of the MW shortfall, to which the causer contribution cost per MW is applied will be developed post the T-3 trigger period by the AER through a rules consultation process.

Procurer of Last Resort causer contribution liability example

Figure 3 provides an illustrative example (showing hour long trading intervals again for simplicity). The reliability obligation has triggered for 2pm – 9pm on 4-6 February 2023. Figure 3 outlines qualifying contracts, scaled load and 5 periods of non-compliance for a liable entity over this 3 day period. This includes a 20 MW shortfall on the Wednesday, two shortfalls on the Thursday (10MW and 30 MW) and two more extensive shortfalls on the Friday (50 MW and 90 MW).

- If the maximum single non-compliance trading interval is applied for causer contribution, the entity is liable on the basis of a 90 MW shortfall.
- If, for example, the average shortfall across the gap is used to as the MW criteria for cost allocation, a much smaller 40MW shortfall is used.
- Finally if the average compliance is used, then there is a total of 200 MW shortfall over the three days, each of 7 hours duration. Therefore the average compliance is 9.5 MW.

This simple example highlights a number of different approaches for the cost contribution calculation.

Figure 3: Outline of compliance assessment over a gap period



Procurer of Last Resort cost allocation

Procurer of Last Resort costs may be allocated to non-compliant entities through two potential approaches:

1. Upfront cost determination and then, after the event, a causer contribution mechanism.
2. After the event cost calculation based on actual Procurer of Last Resort costs and allocation.

Option 1 – Upfront cost determination and, after the event, contribution cost

A liable entity found to be non-compliant will be charged a predetermined cost to offset the Procurer of Last Resort costs.

The fixed cost would be charged for each MW of demand that the liable entity did not have eligible contracts to cover.²

This will make it very clear to liable entities that non-compliance has a clear cost risk.

The cost recovery should be based on a multiplier of the capital cost of capacity - the capital cost could be determined by the Reliability Panel.

For example – diesel generation (including associated fuel storage and other ancillary costs) has a capital cost of say \$1.0m per MW and this equates to an annualised cost is \$0.25m. The cost recovery penalty could be a fixed cost for every MW of actual demand above their contracts position - of say double (or higher) this annualised cost. Using this example of annualised capacity cost as the basis for the imposed cost for non-compliance, there is only a need to penalise once per shortfall period, i.e. once for the entire summer period.

Option 2 – After the event cost calculation and allocation

A liable entity found to be non-compliant will be charged their share of the costs to AEMO of acting as Procurer of Last Resort. This cost would be uncertain until after the procurement has occurred but is likely to be higher than the cost to the retailer of complying with the obligation. This cost will be a price per MW. Using this approach, it is likely that the up-front costs for Procurer of Last Resort are considerably greater than the usage rates. If so then the imposed cost for non-compliance should only occur once per shortfall period.

Preferred approach

- A liable entity found to be non-compliant will be charged a predetermined cost (based on a determination by the Reliability Panel) per MW of non-compliance to refund a proportionate cost of the Procurer of Last Resort costs to consumers.

² This contribution is likely much lower than the total Procurer of Last Resort costs as AEMO procures for a 1 in 10 year peak demand forecast, which is considerably higher than the one in two year peak demand forecast. Therefore the capacity reserve procured is largely for this higher demand requirement. Further, the cost of procuring reserve will likely increase the more that is sought.

7 Compliance and enforcement of the reliability obligation

The AER already has access to a range of compliance tools and discretion in deciding whether to take enforcement action and the nature of that action. In determining an appropriate enforcement response, the AER considers all relevant factors and circumstances.

Enforcement of the reliability obligation will consist of a two-stage approach:

- In the first stage, the AER's assessment would evaluate whether liable entities contracted to a level consistent with their share of system load during the compliance interval. This assessment would identify the extent to which retailers have fallen short of their reliability obligation for the purposes of offsetting the Procurer of Last Resort costs on an automatic formulaic basis.
- In the second stage, the AER would retain its ability to apply its usual suite of enforcement options. These enforcement options would likely only be used for more significant or repeated failures to comply with the reliability obligation.

Whilst the causer contribution calculation that partly refunds the Procurer of Last Resort costs and additional civil penalties form a critical deterrence, and redress, to non-compliance, the AER has a range of additional compliance and enforcement tools to address non-compliance.

Prior to a reliability obligation arising the AER will actively engage with the industry to ensure participants understand their obligations. As discussed above and in other papers, there are a number of elements that the AER will need to provide clear guidance on to ensure the process is readily understood. However, if non-compliance arises, the AER may also exercise the following enforcement powers:

- Administrative undertakings: Administrative resolutions are a more informal and less intrusive enforcement option which the AER uses to resolve certain matters. The AER may be more likely to accept an administrative undertaking where the effect of an actual or potential breach is limited, and a business has taken (or agreed to take) appropriate steps to end the conduct and to remedy any harm done.
- Enforceable undertakings: These are written statements from an entity that it will take specified actions (for example, entering into contracts in order to resolve a breach). Compliance with these undertakings can be enforced by the courts and undertakings are a valuable tool in addition or as an alternative to infringement notices.
- Institute civil proceeding: The AER can initiate civil proceedings in the courts for alleged breaches of civil penalty provisions of the national energy laws:
 - Injunctions: A court may order an injunction requiring a person to do something or desist from doing something.
 - Civil penalties: A court may order that an entity pay a financial penalty as a result of breaching its obligations.

The proposed civil penalties are discussed further in section 7.2.

7.1 Introducing anti-avoidance provisions

The ESB is considering the merits of introducing an anti-avoidance regime in the NEL that relates to the Guarantee to reduce the risk of companies restructuring or taking similar action to avoid their obligations.

In simple terms, a general anti-avoidance regime would prohibit an entity which has a potential obligation under the Guarantee from taking action for the purpose of avoiding that liability.

Anti-avoidance regimes are often included in taxation and revenue laws to prevent tax structuring for the purposes of avoidance. The anti-avoidance regime would be general in its scope, as distinct from specific avoidance or anti-gaming measures which might be included in respect of specific obligations.

Such a provision could help to reduce the complexity of the regulatory framework giving effect to the Guarantee.

Preferred approach

- The merits of including an anti-avoidance provision in the NEL should be considered and consulted on. A general anti-avoidance regime would prohibit an entity which has a potential obligation under the Guarantee from taking action for the purpose of avoiding that liability.

7.2 Penalties framework

In conjunction with this cost allocation mechanism, the AER will have the usual discretion to assess if the identified non-compliance warrants additional court ordered civil penalties.

In addition to the overarching reliability requirement, the AER will also be provided with the enforcement option of pursuing a civil penalty for non-compliance of procedural obligations, such as a liable entity failing to report the contracted position one year before the reliability gap period.

Civil penalties framework

The AER should be able to seek a court ordered penalty against a liable entity found by a court to be non-compliant either with the core reliability obligation or with critical procedural or framework obligations. Any of these penalties for non-compliance could be sought in addition to the cost recovery mechanism.

Civil penalty provisions are an important component of this compliance framework. They are designed to capture a range of potential circumstances that led to non-compliance and then allow the court to allocate an appropriate financial penalty.

The proposed civil penalties should act an effective deterrent for non-compliance and reflect the seriousness of these types of breaches.

The standard civil penalty regime defined under the NEL carries a maximum penalty of \$100,000. This penalty regime is currently subject to review by the COAG Energy Council as part of its *AER Powers and Civil Penalty Regime* review process. If introduced, the proposed changes would

introduce a two-tiered civil penalty limit, with a maximum civil penalty of \$1,000,000 for breaches of some civil penalty provisions.

The enforcement approach for non-compliance with the Reliability requirement of the Guarantee should effectively deter non-compliant behaviour, and the definition of “civil penalty” in the NEL may need to be amended for application in the context of the Guarantee in order to provide for more meaningful upper limits. It is likely that this will need to occur irrespective of the civil penalty changes resulting from the current COAG Energy Council review. There is precedence for specifying exceptions to the standard civil penalty provisions, as this has already been done in respect of rebidding civil penalty provisions.

With this in mind, non-compliance with the core reliability obligation should be up to \$1 million for first offence and up to \$10 million for repeat offences.

In the case of additional key obligations such as the contract reporting requirement or the anti-avoidance provisions there should be a civil penalty of up to \$1 million.

These figures reflect the upper bound of potential court enforceable penalty, and provide adequate scope to apply to a range of potential circumstances. The AER has discretion on the enforcement response, including the level of penalty to seek in any Court proceedings. Enforcement action, including any penalties sought, will be assessed on a case by case basis and is likely to reflect the extent of the non-compliance and the context. The penalty level is ultimately determined by the court.

Preferred approach

- In addition to the Procurer of Last Resort cost contribution, the core reliability obligation will be a civil penalty provision. Further civil penalties will also be attached to key procedural obligations such as contract reporting.
- The definition of “civil penalty” in the NEL will need to be amended for application under the Guarantee in order to provide for more meaningful upper limits.
- Separate upper limits for the civil penalty may be defined – for first-time non-compliance and for repeat non-compliance.

A **Abbreviations and defined terms**

AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
COAG	Council of Australian Governments
C&I	Commercial and Industrial
ESOO	Electricity Statement of Opportunities
ESB	Energy Security Board
Guarantee	National Energy Guarantee
MW	Megawatt
MWh	Megawatt-hour
NEL	National Electricity Law
NEM	National Electricity Market
RERT	Reliability and Emergency Reserve Trader
ROLR	Retailer of Last Resort
Rules	National Electricity Rules

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