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Clare Stark
Australian Energy Market Commission
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17 November 2022

Dear Clare,

Operational Security Mechanism

AGL Energy (AGL) welcomes the opportunity to comment on the Australian Energy Market Commission Operational Security Mechanism (OSM) draft determination.

AGL is a leading integrated essential service provider, with a proud 184-year history of innovation and a passionate belief in progress – human and technological. We deliver 4.2 million gas, electricity, and telecommunications services to our residential, small and large business, and wholesale customers across Australia. We operate Australia's largest electricity generation portfolio, with an operated generation capacity of 11,208 MW, which accounts for approximately 20% of the total generation capacity within Australia's National Electricity Market.

Introduction

AGL appreciates the AEMC's efforts to design a mechanism to value and voluntarily schedule system services in the NEM. We consider that a replacement to market interventions such as directions and the installation of synchronous condensers by monopoly network operators as mechanisms to ensure the adequate provision of system services is long overdue. While we consider the design of the OSM needs significant refinement, we support the key design aspect by which market forces are used to drive the dispatch and investment in system services. We also support the objective of increased transparency of procurement of system services and the unbundling of system services to the extent possible. Our key concerns with the current design are outlined below.

The OSM may not drive investment

AGL is concerned that the OSM may not drive investment given the expectation that participants will bid their fixed and variable costs, without any allowance for scarcity pricing. We suggest that bids must be allowed to reflect the supply demand balance, otherwise undersupply (or near undersupply) conditions will not drive investment. As currently conceived, it appears the AER's market power oversight is designed to ensure this expectation is met, which further undermines the likelihood of efficient price discovery. This design, combined with pay as bid, rather than marginal, pricing will effectively ensure participants are only paid their cost, which will mean the OSM will lock in incumbents and never provide the necessary incentives for new investment.

The pay as bid, rather than marginal pricing, aspect of the design also limits the ability for participants to earn more if they're the cheapest provider, which undermines the incentive for participants to innovate or reduce costs. In the short-term this weakens the ability for a participant to increase revenues, and over the long term it means there will be no progress to a more efficient market overall, to the detriment of consumers.

In addition to prices that reflect the supply demand balance of the required system services, prices should also be expected to vary with the opportunity cost of fuel. Otherwise, a market participant will just be

incentivised to sell their fuel on the open market and there would be no incentive to stockpile fuel if prices are expected to rise. Including opportunity costs in bids under the OSM appears consistent with the proposed design, we nevertheless point out this concern as high prices due to opportunity costs, like scarcity pricing, have a history of being assumed to represent the exercise of market power in the NEM.

Market power

AGL is concerned that the proposed market power provisions of the draft rule will undermine the effective functioning of the OSM by weakening the ability of participants to bid in a way which reflects their costs (including opportunity costs) and the supply demand balance. We consider the proposed AER market power reviews and mitigation measures are too onerous and will be unnecessary if the OSM is appropriately designed.

A presupposition of potential market power issues requires both expected concentrated markets and expected high barriers to entry. If concentrated markets are expected, then the AEMC should define those markets and make it clear for which services they expect markets to be system wide, regional, or local. While system strength as a local requirement may be the service most likely to lead to market power concerns, the contract obligations under the new system strength framework are likely to constrain the bids of most significant suppliers of system strength. It's therefore possible that market power concerns may only relate to uncontracted providers of system strength or other local system services, and that these concerns could be managed through the OSM design rather than through AER oversight. If barriers to entry are low, then the threat of new entry will restrain the conduct of market participants. We therefore suggest that the AEMC ensure that the OSM is designed to ensure barriers to entry remain low and we suggest that this will be best achieved by ensuring that the nature and quantity of the specific system services assessed to be necessary for system security by AEMO to be as transparent as possible.

The market power section of the draft determination distinguishes between 'transient' and 'sustained' market power on the basis that this is the difference between allowable and non-allowable high prices. This distinction comes from an error in the 2013 AEMC *Potential Generator Market Power in the NEM* paper which incorrectly defines market power. Whether prices above short run marginal cost (SRMC) can be attributable to market power will turn on whether they are due to ineffective competition (market concentration combined with high barriers to entry) or an undersupply. If a participant prices above SRMC due to undersupply conditions, this is scarcity pricing which is a necessary signal which drives investment and provides a signal to reduce supply to those who are able to. When undersupply conditions exist even a participant with a tiny market share will price above their SRMC confident that they will still be dispatched even though they hold no market power. Undersupply conditions may be sustained, but only to the extent that they are supressed by new entry or reduced demand as occurred in the NEM once the undersupply conditions caused by the exit of the Hazelwood generator in 2017 ceased. The draft determination suggests the pivotal supplier test as a tool to assess market power, however we note that this test does not distinguish between market power and undersupply and is therefore only of minor value. We suggest that if the AER has a role in determining efficient pricing for system services in the NEM then the framework the AER use for such assessment be clearly defined with allowances for both scarcity pricing and opportunity costs.

Reduced reliance on directions

AGL strongly supports the creation of a system service mechanism with obviates the need for directions and returns directions to their function as a rarely used last resort mechanism. We are concerned that direction of units for system services in South Australia remains a frequent occurrence despite the commissioning of four large network synchronous condensers. We hope that the OSM will eliminate the need for the regular use of directions in the NEM, nevertheless we are also concerned that the OSM design risks being too similar to directions for two key reasons. First, the OSM design does not make it clear opportunity costs and scarcity pricing are permissible in OSM bidding which is consistent with directions compensation which also excludes

an allocation for scarcity pricing and often opportunity costs to the detriment of the directed generator and the market since it means that prices do not reflect the supply demand balance. Second, directions are mandatory and it is unclear that the OSM will be fully voluntary since it is appears likely that any unit deemed necessary will face directions if they don't bid. We also note that if a slow start unit requires a period longer than the OSM bidding timeframe to come online, it's unclear if relying on voluntary bidding will satisfy AEMO that this unit will come online. The AEMC has not suggested that the OSM will eliminate the need for directions, which is understandable, however we suggest the AEMC make it clear when they expect directions for system services will continue to be required alongside the OSM.

Transparency

To drive market provision of system services it is essential that transparent information regarding the system services needed is available to all market participants. AEMO's existing *Transfer Limit Advice* summaries of combinations of synchronous generating units that are required for a secure state are not adequate. We suggest that the OSM rules should include an obligation on AEMO to provide deeper information (for example through the ESOO) which describes existing and expected system service needs and any new resources which may be able to replace those resources. All distinct system service needs should be clearly described where possible, and if a minimum generator combination cannot be broken into distinct system services then the basis for the needed combination should otherwise be made as clear as possible. We expect that this transparency, particularly if it describes both existing and expected system service needs, would lower barriers to entry and provide investment signals to potential new entrant providers of system services.

Future markets for system services

AGL supports the intention to evolve the OSM and to develop separate markets for distinct system services where possible. We consider this will be the best way to create transparent investment signals for essential system services. While the AEMC has suggested committing to reviewing the OSM every four years we suggest it should be reviewed at least every two years. Every evolution the OSM can make away from the initial reliance on scheduling unit combinations to more accurately defining system service needs will create clearer investment signals for these services. We further suggest that the proposed implementation of the OSM, and the proposed review cycle, should not take precedence over the potential creation of a separate market for inertia which we consider should be considered through the formal AEMC rule change process immediately as stated in our response to the AEMC AEMO *Efficient provision of inertia* joint paper.

If you have any queries about this submission, please contact Anton King on (03) 8633 6102 or aking6@agl.com.au.

Yours sincerely,

Liz Gharghori

A/g Senior Manager Wholesale Markets Regulation