AGL Energy Limited
ABN: 74 115 061 375
Level 24, 200 George St
Sydney NSW 2000
Locked Bag 1837
St Leonards NSW 2065
t: 02 9921 2999
f: 02 9921 2552
agl.com.au

Australian Energy Regulator

GPO Box 520

Submitted by email: **RRO@aer.gov.au**

21 June 2019

Consultation on Draft Interim Qualifying Contracts and Firmness Guidelines

AGL Energy (**AGL**) welcomes the opportunity to make a submission in response to the Australian Energy Regulator's (**AER**) Retail Reliability Obligation (**RRO**) Draft Interim Qualifying Contracts and Firmness Guidelines (**Draft Firmness Guidelines**).

AGL is one of Australia's largest integrated energy companies and the largest ASX listed owner, operator and developer of renewable generation. Our diverse power generation portfolio includes base, peaking and intermediate generation plants, spread across traditional thermal generation as well as renewable sources. AGL is also a significant retailer of energy, providing energy solutions to around 3.5 million customers throughout eastern Australia.

In addition, AGL is continually innovating our suite of distributed energy services and solutions for customers of all sizes. These behind-the-meter energy solutions involve new and emerging technologies such as energy storage, electric vehicles, solar PV systems, digital meters, and home energy management services delivered through digital applications.

Basis for the development of the Draft Firmness Guidelines

The objective of the RRO framework developed by the Energy Security Board (**ESB**) is to unlock investment in new capacity and demand response in order to meet demand during a forecast capacity shortfall (Reliability Gap). To meet this objective, the ESB and COAG Energy Council have determined that liable entities will be required to enter into a minimum level of firm contracts for the provision of electricity during forecast Reliability Gaps. The costs of meeting this obligation would therefore support new capacity and demand response, which would improve reliability outcomes in the NEM.

The effective operation of the RRO in meeting these reliability objectives at a reasonable cost for end consumers depends directly on settings in the Draft Firmness Guidelines, which will determine the way that liable entities can manage financial exposure in the NEM during a period of forecast shortfalls. The Draft Firmness Guidelines are therefore critical in the overall effective operation of the RRO mechanism and the way that the underlying contract market will continue to support the energy market.

Short term and transitional impacts

While the AER has a directive to develop the Draft Guidelines in accordance with the Final Rules package developed by the ESB, the impact of these Guidelines must be broadly considered alongside other electricity market objectives, such as improving contract market liquidity, driving contract innovation, maintaining effective competition, and reducing prices for customers.

In our view, the impact of prioritising a prescribed level of firm contracting over the efficient dispatch of resources is a significant change to operation of the wholesale market. If that transition is implemented poorly, the outcome might be reduced spot market efficiency and a deterioration of the operation of the underlying contracting market, without any new investment in supply as the RRO intended.

Principally, liable entities mange their exposure to wholesale spot prices in the most efficient way possible to minimise end costs to customers. It must be recognised that prescribing the way liable entities manage their wholesale market risk should only be done if there is a commensurate benefit that would clearly meet the objectives of the RRO. At each stage in the process the AER should consider this competing tension between the benefits of dynamic contracting efficiency and the fixed costs of increased forward contracting.

In our view, underlying Rules and Guidelines that support the RRO should therefore not be set so strictly that compliance with the RRO creates a significant distortion to the current efficient operation of the contract market. Rather, the RRO should be designed in such a way that it meets it primary aim of fairly allocating the cost of emergency reserves to participants that choose to remain unhedged during periods of peak demand with minimal compliance overheads to liable entities.

For this reason, our responses to the consultation on the Draft Firmness Guidelines favour settings that will enact a mechanism that is as simple and non-distortionary to the market as possible, including support for greater opportunities to present bespoke methodologies that meet the objectives of the RRO and are consistent with the firmness factor principles.

We consider that flexibility will lead to lower costs on consumers as a result of a decreased compliance burden and risk overhead on liable entities. Firmness settings that are less prescriptive in the first instance will also result in a decreased risk of material price increases and competition concerns. During a period of significant structural change in the national energy market, these are critical considerations to keep in mind for policy makers.

South Australian derogations

We also note that the Government of South Australia is currently considering derogations and amendments to the proposed RRO framework. The uncertain impacts of these derogations creates additional complexity for energy participants when assessing these Draft Guidelines. The risk of different timing requirements for SA must be recognised as a significant barrier to realising the benefits associated with the broader RRO policy aim of creating investment certainty and stability in the forward market.

Further feedback in relation to Draft Firmness Guidelines is contained in **Appendix A** to this submission.

Should you have any questions in relation to this submission, please contact Aleks Smits, Manager Policy & Research on 03 8633 7146, or myself on 03 8633 7252.

Yours sincerely,

Eleanor McCracken-Hewson

Senior Manager Policy, Research & Stakeholder Engagement, AGL Energy

Appendix A – Further feedback on Draft Firmness Factor Guidelines

Principles for firmness adjustment of qualifying contracts

Principles for the firmness adjustment of contracts are critical in the operation of the RRO. To the extent possible, we therefore consider that the Draft Firmness Guidelines should be flexible in their assessment of qualifying contracts. Overly prescriptive criteria could have a material impact on the way in which participants must meet their RRO obligations, which could have significant impacts on the structure of investment in the NEM and the operation of the NEM financial market.

We broadly agree with the criteria set out by the ESB in assessing the firmness of contracts but note that these principles should not stifle contracting innovation and the ability for market participants to dynamically manage their portfolio to reduce costs for customers, including accessing interregional generation and developing innovative contracts to meet their obligations, as well as utilising useful hedging products with firmness factors that may be difficult to assess.

On balance, we consider the process to apply entirely consistent firmness methodologies across the market will be extremely difficult for both liable entities and the AER, and that assessment of overall firmness position is likely to require the independent assessment of each liable entity's position. Even if some standard contracts have a default methodology, the interaction and synergies between non-standard and standard contracts is likely to require bespoke assessment. Each liable entity will take a different approach to hedging practices and methodologies will need to reflect these differences.

We also note the risks associated with a generic assessment of firmness factors prior to any worked examples of this methodology being consulted upon in more detailed with participants. We consider that much more significant consultation should occur on indicative firmness methodologies prior to the final guideline, including detailed assessments of the impact of assignment of various firmness factors, to ensure that the firmness methodology does not create unanticipated impacts on participants and potentially consumers through increased pricing. Real world examples that take account of market complexities would be more useful than simple arrangements.

Firmness factors for some contracts may also change over time as market conditions change and firmness methodologies may therefore also need to be revisited on an annual basis. Rather than prescribe this process, we consider that this may again raise an argument for a more flexible compliance approach to assess firmness rather than attempts to comprehensively set methodologies that are unlikely to be resilient to change.

Given these broad complexities, we consider that as guiding principles, methodologies to assess firmness should be flexible and resilient to change, not be overly harsh or prescriptive, limit administrative overheads and compliance costs for participants, and not stifle contract innovation and negotiation. In our view, this generally points also towards the broader application of more bespoke methodologies rather than the use of standard methodologies proposed in the Draft Firmness Guidelines.

Operation of the Draft Guidelines

The status of the Draft Guidelines to inform compliance obligations needs to be clarified, as it is not clear as to which guidelines would need to be applied during certain periods; for example, in the event of the South Australian Government triggering the RRO prior to the end of 2020.

Standard firmness methodologies that are unduly prescriptive or result in weak firmness factors during the interim period may result in unanticipated consequences, and resolving these only with the application of the final guidelines at the end of 2020 may be too late, especially if the RRO is triggered in SA in 2019.

We therefore consider that the interim framework might benefit from flexibility in the assessment of firmness during the interim period by allowing the broader application of bespoke methodologies.

Standard and non-standard qualifying contracts

The intention of nominating standard qualifying contracts was to reduce the compliance overheads associated with assessing common financial instruments used by liable entities to manage their position in the market. However, in working through examples, it has become apparent that applying standard methodologies for most qualifying contracts is not a simple process.

With perhaps the exception of swaps, which have been assigned a firmness factor of 1, the calculation of firmness for other standard qualifying contracts includes assessment against a number of more complicated factors beyond the simple volume and duration of the contract.

As a result, while we consider it is useful for the AER to consider standard methodologies in more detail and to continue to try and find efficiencies in determining firmness factors, we consider that as an interim measure participants should be able to assign their own methodology to assigning firmness, as long as it is consistent with the RRO principles outlined in the guideline including independent assessment by an approved auditor. This should apply to both standard and non-standard qualifying contracts.

Methodologies for qualifying contracts

There are a number of concerns with the methodologies proposed for most standard qualifying contracts. While we consider it is useful for the AER to continue to examine these concerns and aim towards standard methodologies, it seems unlikely that these concerns will be fully resolved prior to the publication of the interim guideline this year. As a result, it may be appropriate that at least as an interim measure, bespoke or flexible methodologies should be able to be applied to all categories of contracts. At a minimum, we consider that only the proposed methodologies for swaps and caps is sufficiently clear to proceed with under a standard methodology.

Caps with a strike price less than or equal to 5% of the MPC (i.e. currently $725) will be considered firm with a sliding scale as the strike price increases. While the current strike price of caps is generally $300, we agree that some buffer is probably required to allow for innovation and change in the contracts market. In our view, the sliding scale towards the MPC however seems fairly prescriptive. In the future there may well be important technologies that can provide cap cover at prices trending towards MPC, which require a high strike price for very few trading intervals to recover their costs. In our view, more work needs to be done to understand the impact that assigning a very low firmness factor to caps offered by these technologies will have, especially when the technology may indeed be extremely firm.

Options may need to be assessed within a bespoke methodology due to peculiarities associated with their operation in the market. For example, given that the liable entity's NCP is reported at T-1, options will likely have a low firmness at this time while being much more firm closer to T, depending on changing conditions such as option delta. While the AER could propose a starting point for a standard methodology, it is our view that options may therefore require a more bespoke methodology that takes account of changes in delta and exchange volatility, which if used to assign firmness on certain dates could be very uncertain and subject to material fluctuations. In any event, options are important established tools for risk management and should not be disincentivised purely because they are assigned a poor firmness at T-1. We consider there should be a more bespoke way of assessing the overall integration of options into a contract portfolio that can assign firmness of options based on their synergies with other contract positions.

Load-following hedges, PPAs, and vertically integrated generation raise similar issues in terms of the forecast load of each arrangement to inform a volume for the firm contract. There is likely to be a disconnect between the reporting of buyer and seller contracts as they are based on different forecasts; the

buyer would receive a firmness of 1, but the volume of the contract may not be clear until settlement. To clarify this disconnect, again this is likely to require a more bespoke approach depending on the particular generation asset that the contract is being written against and the way a load following contract is being used as a part of an overall contract portfolio.

While the AER has noted that historical performance of the generator would be assessed against other criteria (such as outages and upgrades), in our view a better metric to use might be the generator's own assessment of the unit taking into account information provided to inform PASA (as long as that measurement is consistent with other factors). The synergies from interactions with these positions with other firming contracts will be important as well. For example, while a particular load-following hedge may have a firmness factor that is lower that 1, the combination of that hedge with a firming contract such as demand response may mean that the contracts is actually fully firm for the entire Reliability Gap. Assessment of these synergies and overall portfolio firmness will be even more critical than individual contracts, which are complications that again point to a non-standard or bespoke approach being more applicable for these categories of contracts.

Demand response contracts should be considered firm despite the AER's reference to 'control' over the curtailment conditions. Just as liable entities will not have direct control over generation units, they do not have control over demand response. Firmness may therefore depend more on confidence that demand response contracts will be exercised, which again is related to more subjective criteria and therefore more likely to require a bespoke methodology for assessment.

The methodology does not seem to address other instruments such as callable options (for example day ahead products) and dispatch right or tolling agreements. Some indication of the assessment of these products would be helpful as they clearly would meet the definition of qualifying contracts. Similarly, other products such as forced outage insurance products could be included to help firm generation and mitigate conservative reliability assumptions; however, it is not clear how these might be treated under the Guidelines. Lastly, firmness factors for derivatives with daily/term limits may be open to an entity's interpretation and may require a bespoke methodology to be developed.

Audit framework

In reviewing the Draft Firmness Guidelines, it seems likely that the utilisation of bespoke methodologies will be more broadly applied than perhaps anticipated by the ESB or AER when developing the RRO framework. Therefore, availability of sufficiently qualified auditors that are able to advise and provide assurance on these matters will be important to the overall operation of the RRO.

We understand that the nomination of auditors will include both traditional audit and assurance companies as well as the inclusion of individuals with sufficient expertise and experience in financial and energy markets. We are supportive of the AER allowing a broad range of individuals into the audit panel, but consider that there may be some significant work required between prospective auditors and the AER during the audit process, and that sufficient resources should be allocated to ensure ongoing questions regarding firmness methodologies can be resolved in an efficient manner.

Especially if the RRO is triggered in South Australia this year, we consider that the nomination of sufficiently qualified auditors will need to occur as soon as possible to allow liable entities to commence compliance activities. Where sufficiently qualified auditors are not available, this should be considered in the AER's assessment of an entity's ex post compliance.

The power to undertake spot audits of a liable entity's NCP and adjust the firmness factor of certain contracts seems to be outside the remit of the AER's powers to *monitor* compliance. Under the RRO framework, approved auditors can provide assurance that an approved methodology was followed and applied correctly.

Spot audits to monitor this process are within the AER's powers, but we consider that the AER may not be empowered under the Rules to adjust firmness factors following an audit. Indeed, Rule 4A.E.5(e) of the NER states that a bespoke firmness methodology and firmness factor approved by an Independent Auditor and included by a liable entity in its NCP report is binding on the AER in the absence of fraud or manifest error.

In our view, the best interpretation of this Rule is that firmness factors as approved by auditors are binding on the AER, but can be adjusted to take account of manifest errors during the compliance assessment process for compliance trading intervals following the end of the reliability gap period.