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Australian Energy Market Commission

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Inter-regional Settlements Residue Arrangements for Transmission Loops – Directions Paper

AGL Energy (AGL) welcomes the opportunity to respond to the Australian Energy Market Commission (AEMC) Inter-regional settlements residue arrangements for transmission loops Directions paper consultation.

AGL does not support the AEMC's "netting-off" proposal

We do not support the AEMC's proposal to net-off negative residues from positive residues for transmission loops. We consider this is a very substantive decision that is expected to have far reaching implications for the market and customers, increasing risk and cost. The AEMC's proposal will reduce the effectiveness of interregional hedging, reduce market competition, and result in higher electricity bills for customers.

Settlement residue auction units (SRAs) are a key instrument in managing inter-regional price risk. Managing inter-regional risk boosts liquidity in the electricity financial market and provides retailers with more tools to manage spot price risk. Retail electricity customers are not exposed to spot prices. Retailers are responsible for purchasing electricity from the wholesale market and managing risk using different tools (financial instruments, participating in generation) and then on-selling to customers through retail contracts. SRAs enable retailers to manage risk in their portfolios and offer competitive retail contracts to customers.

The AEMC's proposal will directly undermine the value of interregional hedging and consequently the efficiencies from interconnection in the NEM. This is entirely antithetical to the intention of the original rule change request from the Australian Energy Market Operator (AEMO) which sought regulatory changes to promote efficient dispatch ahead of Project Energy Connect (PEC) stage 2 and the transmission loop it will create, and not to redefine the purpose of SRA units.

We do not agree that the AEMC's approach will save customers money. The "netting-off" proposal will reduce the value of SRAs. This will increase hedging costs for retailers and ultimately costs for customers. If retailers cannot efficiently hedge across regions they will need to hedge within region. This will require additional generation/storage (and potentially network build) in each region, reducing the value of the customer funded interconnector.

Higher costs for interregional hedging & higher costs for customers

The AEMC has stated it considers its proposal (netting-off negative and positive residues) places the risk with the parties best able to manage it and at the lowest cost for customers and reflects the interconnectedness of the loop. We do not agree this is the case.

SRA units are financial products which allow retailers to hedge load in a particular region by buying the 'rights' to the positive residues that accumulate between regions.

- As an example, if the NEM spot price in South Australia was $1000/MWh and the price in Victoria was $100/MWh, electricity would normally flow from VIC into SA. If 500 MW of electricity was flowing across the interconnector, generators in VIC would be paid $100/MWh for this 500 MW, but customers in SA would be paying $1000/MWh for the same 500 MW. The residue that accumulates would be ($1000 – $100) * 500 = $450,000.
- Buying an SRA unit from VIC to SA allows the purchaser to have a share of this residue. This has a similar financial impact to buying a hedge product in SA itself.
- Negative residues accumulate across an interconnector when the flow across the interconnector is counter to price (instead of low to high price it flows from high to low). These occur now with the current interconnectors but are generally more limited.

- The commissioning of Project EnergyConnect will introduce a loop flow where negative residues will accumulate naturally as part of the electrical configuration; this is not undesirable as it is simply a consequence of efficient dispatch.

The AEMC's Draft Determination would have continued the current approach whereby negative residues accumulated across interconnectors are paid for by customers in the importing region via their transmission network service provider (TNSP). The logic is that customers in the importing region are receiving a lower wholesale cost than they otherwise would by allowing the counterflow to occur. The AEMC's latest proposal would offset negative residues against positive residues **on a different leg of the interconnector.**

- For example, a holder of a VIC to SA SRA unit could have the payouts reduced by negative residues on the NSW to SA leg.
- Although there is a theoretical economic justification for this approach, this will significantly reduce the effectiveness of SRAs as an inter-regional hedging tool because of the significant uncertainty in the payouts in both timing and magnitude.

Retailers will have to procure contracts from the financial market as an alternative to procuring SRAs to hedge their load (for example in SA retailers currently use SRA units as an alternative to buying caps for hedging their load against the SA price). This increased demand will likely increase the price of the hedge products. These costs will ultimately be passed through to customers resulting in higher electricity bills.

This will also likely require additional 'in-region' generation that will increase overall system costs and remove much of the justification for interconnection to begin with.

The AEMC's proposal undermines efficiencies from interconnection, stifles market competition, and encourages jurisdictional generation build

By reducing the market's ability effectively manage interregional price risk, the AEMC is encouraging jurisdictional generation build and undermining efficiencies from interconnection.

In particular, the AEMC's proposal may drive up the costs for retailers with customers in South Australia due to the generation mix and limited contract options available.

Smaller retailers, lacking any generation coverage, will be most impacted by the AEMC's proposal as these businesses will have higher contracting costs to hedge their load. This will inhibit market competition in the NEM.

We consider the AEMC's proposal is antithetical to the original rule change request, the National Electricity Objective, historical Coordination of Generation and Transmission Investment Implementation (COGATI) decisions which were meant to promote the benefits of interconnection, as well as the stated objectives of the Wholesale Market Settings (Nelson) Review.

The rule change process has been drawn out while simultaneously not meeting the minimum standards expected from regulatory consultations

We note the AEMC has shifted its position since the Draft Determination primarily due to concerns around the impact of potentially large negative residues on TNSPs and ultimately customers.

We consider this concern would be best addressed through appropriate consultation on different options instead of prematurely committing to a final solution.

The AEMC released a Draft Determination earlier this year which received general support from stakeholders. The AEMC subsequently held private technical working group discussions due to concerns raised by TNSPs after the public draft consultation period had concluded. The AEMC has since completely changed its position in its latest Directions paper without appropriate public consultation.

This change has been introduced late without proper consideration of all alternatives, including whether the solution is not worse than the underlying problem.

The AEMC has not engaged in a transparent manner and allowed adequate opportunity for public scrutiny of all possible options. The lack of transparency and consistency in the consultation process greatly undermines the latest recommendations made by the AEMC.

TNSPs are best placed to manage negative residue risk

We do not agree that market participants are better placed to manage the risk from large negative residues compared to TNSPs. TNSPs have access to financing options that are generally cheaper than for retailers/generators. They are best placed to manage the risk of negative residues.

TNSPs hold a monopoly position in the NEM with large asset bases that are typically many times larger than that of retailers/generators. TNSPs are regulated monopolies with stable, long-term revenue streams approved by the Australian Energy Regulator (AER). Their revenues are determined through periodic regulatory determinations based on efficient capital and operating expenditure forecasts, and a benchmark rate of return. This regulatory certainty, combined with their essential infrastructure role and lack of direct competition, significantly reduces their risk profile for investors and lenders. As a result, TNSPs are typically able to access capital at lower cost compared to competitive market participants such as generators or retailers, whose revenues are exposed to volatile market conditions, policy shifts, and customer churn. Competitive players face greater commercial risk, which translates into higher financing costs.

Alternative options

We consider TNSP cashflow concerns should be addressed through a separate process as this is not within the original scope of this rule change process.

Some options which could be explored in more detail to manage the potential large and unpredictable cashflows are:

- Changes made to the rules to allow TNSP's to manage this more effectively by giving more flexibility in their recovery from customers.
- Recovery through normal AEMO market recovery processes, e.g. directions.
- Funding from a combination of SRA auction proceeds and potentially delaying payments to positive holders to finance cashflows once a certain threshold of negative residues has been reached (on the understanding that very high positive cashflows have accumulated in these circumstances).

Ultimately, the AEMC has not undertaken the work to develop alternative options, nor have stakeholders been given an adequate opportunity to analyse and consider different options. We note the development of this rule change proposal in conjunction with the AEMC's consultation process has taken place over a number of years only for a major change to be introduced at a very late stage in the process by the AEMC. This does not represent good regulatory practice or provide confidence in the final solution.

Proposed review of SRA arrangements

We do not support the proposed review of the SRA arrangements. We consider such a review would be premature given the uncertainty in market outcomes once PEC commences operation. We note PEC is scheduled to commence operating at partial capacity in Q4 2026 and ramp up to full capacity by late 2027. We recommend that the AEMC only consider a review of SRA arrangements after PEC has been operation at full capacity for at least 24 months. This will allow adequate time to evaluate whether the regulatory settings are operating as intended and a suitable period of empirical data to analyse.

We emphasise that SRAs are not used by retailers to achieve large "windfall" gains but rather as a sophisticated hedging tool as part of a broader risk management portfolio. If tail risk is consistent across SRAs then it will get factored into SRA auctions and drive-up auction proceeds.

We also note there are the significant number of regulatory reviews and processes currently underway which will affect the wholesale energy market; we consider a review of SRA arrangements should be undertaken at a later stage once fundamental regulatory processes such as the independent National Electricity Market wholesale market settings review have been completed.

About AGL

At AGL, we believe energy makes life better and are passionate about powering the way Australians live, move, and work. Proudly Australian for more than 185 years, AGL supplies around 4.5[1] million energy, telecommunications, and Netflix customer services. AGL is committed to providing our customers simple, fair, and accessible essential services as they decarbonise and electrify the way they live, work, and move.

AGL operates Australia's largest private electricity generation portfolio within the National Electricity Market (NEM), comprising coal and gas-fired generation, renewable energy sources such as wind, hydro and solar, batteries and other firming technology, and storage assets. We are building on our history as one of Australia's leading private investors in renewable energy to now lead the business of transition to a lower emission, affordable and smart energy future in line with the goals of our Climate Transition Action Plan. We'll continue to innovate in energy and other essential services to enhance the way Australians live, and to help preserve the world around us for future generations.

If you have queries about this submission, please contact Alifur Rahman at ARahman3@agl.com.au.

Yours sincerely,

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Policy & Market Regulation

AGL Energy

[1] Services to customers number is as at 31 December 2024.