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Australian Energy Market Commission (AEMC)

Via AEMC website: www.aemc.gov.au

Inter-regional settlements residue arrangements for transmission loops – Directions Paper

Alinta Energy welcomes the opportunity to provide feedback on the AEMC's directions paper aimed at establishing the requisite arrangements for inter-regional settlements residue (IRSR) for the PEC project.

Key points:

- **We strongly oppose the proposed 'netting off' approach, which we consider to be short-sighted and anti-competitive.**
- **The proposal represents an abrupt change of approach. It shifts focus to addressing a valid but discrete CNSP cashflow concern and inadvertently creates a more significant issue by devaluing SRA units.**
- **SRA units play a critical role in enabling robust competition in retail markets, particularly in regions with limited wholesale market liquidity.**
- **We consider that the proposed 'netting off' solution will fundamentally undermine the value of SRA units, disrupt market competition, fail to reduce consumer costs, and is inconsistent with the National Electricity Objective.**
- **We recommend that the AEMC adopt either the proposed solution in the draft determination, or AEMO's original proposal, and undertake a separate review on how to address CNSP cashflow concerns.**

The proposal represents an abrupt change of approach. It shifts focus to addressing a valid but discrete CNSP cashflow concern and inadvertently creates a more significant issue.

We acknowledge the operational challenges introduced by PEC that warrant the AEMC's consideration. We understand, given the nature of how power flows in the loop as compared with radial interconnectors, that there is an increased likelihood of negative residues via the spring washer effect, and this could cause negative residues of up to $40 million on a quarterly basis (with clamping)[1]. Accordingly, AEMO's rule change request was driven by the need to address how negative IRSR allocations are managed in this scenario.

[1] The AEMC Directions paper, p 34.

Alinta Energy recognises the valid concern of coordinating network service providers (CNSP's) within this context. That is, they will have increased cash flow risk exposure[2] arising from the potential volatility and magnitude of negative IRSR.

The draft determination acknowledged and responded to this concern[3], recommending that:

- the negative IRSR allocation method that best manages the risk of extreme negative IRSR and produces cost-reflective outcomes, is sharing negative IRSR by regional demand;[4]
- positive IRSR would continue to be allocated through the settlement residue auctions (SRA) process;[5]
- clamping of the loop would only occur when net IRSR is negative;[6] and
- CNSP cash flow concerns could be addressed via debt facility arrangements or the focus of a separate rule change request[7].

In the draft determination, the AEMC referenced "balanced"[8] consideration of all stakeholder feedback against its assessment criteria to "develop a draft rule that we consider best serves the long-term interest of consumers as per the NEO"[9]:

- It was recognised that "a majority of stakeholders"[10] preferred an approach in which *only negative* IRSR allocation was within scope, as proposed by AEMO[11];
- The Commission acknowledged "Market participants want the value of SRA units maintained"[12] as a means of managing risk and promoting inter-regional trade;
- TNSP feedback was incorporated in the draft determination, with the AEMC amending the negative IRSR allocation method from AEMO's proposal to that of regional demand[13] in the draft rule.

In light of this, the directions paper represents an abrupt change in approach and focus. Whereas the draft determination aimed to balance numerous interests, the updated proposal centers on re-addressing CNSP cashflow concerns - previously dealt with in the draft determination, targeting one aspect of the PEC situation, rather than its cause. In doing so, the updated proposal inadvertently risks delivering worse outcomes overall for all market participants.

As underscored by the AEMC in the directions paper, the *fundamental issue* the netting off solution proposes to mitigate is the "cash flow risks that arise under non-netted approaches"[14]. By proposing a netting off approach to address this undesirable but discrete outcome of the PEC loop's operation for networks, the AEMC has introduced a more significant problem - undermining the value of SRAs, which has market-wide implications. We consider that the AEMC's revised approach directly contradicts much of its rationale for how it assessed its recommendations in the draft determination[15].

Below, we outline the impact this proposal will have on the nature and value of SRAs, with

[2] Refer to ENA and Transgrid submissions to the Draft determination.
[3] The AEMC Draft determination, p 21 – 23.
[4] The AEMC Draft determination, p 25 – 26.
[5] The AEMC Draft determination, p 28.
[6] The AEMC Draft determination, p 9.
[7] The AEMC Draft determination, p 23.
[8] The AEMC Draft determination, p 8.
[9] The AEMC Draft determination, p 8.
[10] The AEMC Directions paper, p 25.
[11] The AEMC Draft determination, p 29.
[12] The AEMC Draft determination, p 3.
[13] The AEMC Draft determination, p 3.
[14] The AEMC Directions paper, p ii.
[15] The AEMC Draft determination, p 2 - 11.

an outcome that is ultimately more detrimental for customers and market competition.

SRAs play a key role in competition and portfolio risk management for market participants

As one of Australia's largest energy retailers, Alinta Energy recognises the vital role that SRAs play in supporting strong retail competition. The primary use of SRAs for market participants is to enable hedging of inter-regional price risk, particularly in regions with limited wholesale market liquidity.

By leveraging this risk management tool, retailers are able to service our customers in an efficient, affordable way. The draft determination acknowledged that "Positive IRSR […] ultimately flows through to consumers"[16]. This occurs via the proceeds CNSPs receive from the auctions. Retailers who face price differences due to lower generation prices in one region, and customers located in a higher priced region - can use SRA units to hedge and offset the risk of potential spot market losses.

This enables retailers to service more regions and more customers, fostering increased market competition. In addition to these benefits, TNSP's receive revenue from SRA proceeds, which further contributes to reducing consumer costs via transmission prices.

The proposed 'netting off' solution will fundamentally undermine the value of SRA units and disrupt market competition

The proposal will undermine both the value of SRA units in financial terms and as a hedging instrument. Deducting negative residues from positive - 'netting off' – will:

- reduce the correlation of SRA units to inter-regional price differences, resulting in lower confidence in using the instrument by market participants; and
- nullify the value of SRA units as a risk management tool for inter-regional price differences, hindering the ability of market participants to use them as a hedging instrument to manage their exposure.

The greatest impact of the netting off approach would occur in South Australia (SA), where liquidity is already the lowest in all NEM regions: ASX Open Interests in all exchange traded products across the terms within 2026 (as of 7 July 2025 Close) show SA contracts providing only ~1% of all Open Interests across ASX NEM markets.

In this context, the use of SRA units as an inter-regional hedge are effectively a pre-requisite to servicing customers in SA for retailers without generation assets in the state. Given this lack of liquidity, a 'netting off' approach, would further exacerbate the risks for retailers. The impact of this approach on market participants is manifold, and will ultimately:

- decrease the appetite of (the already limited amount of) traders to continue participating in the market;
- increase market participants' trading risk profiles, hindering their ability to gain approval from their internal Board and Energy Risk Policy to continue servicing customers in SA as a retailer;
- increase the likelihood that retailers would be forced to withdraw from the SA market, especially for tier 3 retailers who have limited cash flow and will be unable to shoulder the increased risk to inter-regional price differences; and
- further entrench the market power of large vertically integrated participants in South Australia who will stand to benefit from inter-regional retailers pulling out of the

[16] The AEMC Draft determination, p 29.

market due to this increased risk or alternatively being compelled to purchase SA hedges from these large participants at increased prices.

Further, the AEMC centres their argument around the notion that because the operational nature of the loop is different from other interconnectors (as noted above), the value of SRAs will consequently change. We consider that this ignores the fundamental role of SRAs in supporting competition, as outlined above.

We note the AEMC has listed as one of their three key reasons for netting off in net negative cases, that "it avoids the potential for gaming"[17] from generators that hold SRA units. Currently, retailers and gentailers have extensive legislative and regulatory obligations related to competition and bidding practices. Failure to adhere to such obligations results in often significant financial penalties and reputational damage. The notion that the 'netting off' theory would reduce 'gaming' from market participants fails to acknowledge the possibility that under a netting off approach:

- Market participants who have generation on opposing borders within the loop and *aren't reliant on SRAs* stand to benefit from increased periods of negative flows;
- The likely exit from the SA market from retailers would leave substantial market power to the remaining generators in the state, resulting in an effective duopoly with the ability to maximise customer prices.

Concerningly, the directions paper addresses the "possibility that netting off may undermine the perceived hedging ability of SRA units to such an extent than stakeholders become less interested in buying them or no longer wish to buy them at all"[18]. However, the AEMC does not believe this to be a likely scenario, with the expectation that SRA units "would be sold even if payouts are uncertain or expected to be low"[19].

We note that in the published submissions to the draft determination, eleven out of the fourteen respondents were supportive of the AEMC's prior solution which did not net off. The three respondents who were unsupportive of this approach were Energy Networks Australia, Transgrid, and the EUAA[20]. We would recommend the AEMC reconsider what we believe to be an incorrect assumption of market participants' continued desire to purchase SRA units in a netting off scenario given the magnitude of support for a non-netting off approach.

The proposed solution will not result in the lowest costs nor best outcomes for customers

In making this proposal, it is evident that the importance SRA units in supporting competition and their value to the market, especially in SA, has not been properly accounted for.

Despite acknowledging the value of SRA units to customers[21], there remained uncertainty from the AEMC around the potential impacts to consumers of frequent negative IRSR.[22]. Whilst we appreciate the AEMC's concern around the consequences of negative residues due to the operational nature of the PEC loop, there is no direct connection between market participants using positive SRA units as an inter-regional hedge and the expected magnitude of negative IRSR arising due to the operational constraints posed by the PEC loop. A removal of negative residues from the net total does not provide a commensurate decrease for customers, who will face additional costs from market participants unable to manage

[17] The AEMC Directions paper, p 33.
[18] The AEMC Directions paper, p 19.
[19] The AEMC Directions paper, p 19.
[20] Refer to the respective submissions to the Draft determination.
[21] The AEMC Directions paper, p 7.
[22] The AEMC Directions paper, p 4.

these risks under a netting off approach.

As we have highlighted, the fundamental purpose of SRAs is to manage inter-regional price risks for market participants in order to benefit consumers, not as a transfer of wealth from consumers to retailers. We consider that the proposed netting off approach on customers will:

- Diminish retailers' ability to hedge inter-regional risk, limiting their ability to use SRAs and increasing costs through reliance on intra-regional hedges or energy;
- Increase retailers' risk profiles, limiting their willingness to continue engaging in an illiquid market without hedging instruments, leading to them unable to continue servicing customers in SA as a retailer (with small retailers at particular risk);
- Reinforce the market power of SA generators who are likely to benefit if inter-regional retailers withdraw from the market due to heightened risk, resulting in likely cost increases for customers;
- Decrease revenues received by TNSPs from SRA auctions, reducing the subsequent flow through to customers;
- Fail to reduce costs in equal measure to the negative residues 'netted off' through the added costs listed above.

At this time, without the loop operational, the magnitude of impact from negative residues incurred on the PEC loop is theoretical. In the absence of concrete data, it is impossible to quantify the cost of increased negative IRSR, and the subsequent impacts from reduced SRA revenues and changes to market participant involvement in SRAs or regions.

This ambiguity is a further reason as to why the approach in the draft determination should be adopted. Weighed against an uncertain outcome with respect to the potential prevalence of negative residues and their implications for the cash flows of CNSPs, we consider that the dismantling of an established and vital risk management instrument is disproportionate, short-sighted and anti-competitive; especially considering the cash flow issue may be dealt with discretely.

Compared with the draft determination, the proposal is inconsistent with the National Electricity Objective (NEO)

In the directions paper, the AEMC has reinforced its obligation under the National Electricity Rules[23] to make a rule "only if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NEO"[24].

The AEMC has outlined three assessment criteria it has used as the basis for assessing its proposed rule change: outcomes for customers; principles of market efficiency; and principles of good regulatory practice.

We believe the netting off approach fails to adequately satisfy the criteria and its ultimate contribution to achieving the NEO, considering that:

- Customers would be worse off as compared with the draft determination, there would be less revenue allocated to TNSPs – increasing TUOS costs, less competition in SA from retailers leaving the market due to increased risk will increase retail prices for SA customers, and increased wholesale costs for remaining retailers due to high intra-state hedging or energy purchase costs;
- The approach is likely to result in less retailer presence in SA, reducing competition

[23] Section 88 of the National Electricity Rules.
[24] The AEMC Directions paper, p 45.

and thereby undermining principles of market efficiency.
- The proposal appears inconsistent with principles of good regulatory practice. The draft determination was reversed in a matter of months with deference to the views of the majority (eleven of fourteen) of respondents who voiced their support. It also contrasts with the draft determination which noted that maintaining SRA arrangements "provides stability and consistency for the market and consumers"[25].

The AEMC has now formed the view that maintaining the arrangements for IRSR allocations outlined in the draft determination would not promote the NEO. Noting the arguments outlined above, we strongly disagree. We consider that the AEMC has not provided sufficient rationale for its reversal from the draft determination which maintained that the previous approach as would best serve the long-term interest of consumers[26]. We question the rationale for the AEMC's reversal on its application of the assessment criteria in addressing the NEO.

Risk allocation for expected negative IRSR is best placed with CNSPs

As mentioned, the fundamental purpose of SRAs is to manage the risk in inter-regional price differences. This supports competition in regions where it is otherwise difficult contract supply, including SA. The risks arising from the PEC project are fundamentally driven by physics and not market behaviour. Market participants are confined to the use of SRAs to manage such variations in physical aspects of the networks and the nature in which generation flows inter-state to where load requires it.

The argument that market participants are better placed to manage negative IRSR risk compared with CNSPs is unpersuasive, considering that:

- Without the use of un-netted positive SRAs, market participants have no other recourse that provides the same level of efficiency and cost to manage this risk;
- Faced with the reality of an increased inter-regional risk profile, market participants are highly likely to withdraw from markets (particularly small retailers), or to apply a risk premium in wholesale costs;
- An additional deleterious consequence to this approach is that by undermining the ability of market participants to use SRAs effectively as a hedge, flow-on increases in wholesale costs will not be transparent nor understood by customers. This places additional undue risks on market participants, who will suffer the impacts of reduced competition under this approach to address a short-term cash flow concern of TNSPs.

The same points cannot be said for CNSPs, who, despite facing cashflow challenges in this situation are better placed to absorb these risks as large businesses with substantial asset bases and regulated returns. And unlike market participants they would not be compelled to withdraw from markets.

Ultimately, we believe the netting off process undermines its intention to improve outcomes for customers by putting market participants at the forefront of managing these risks. The outcome of this will threaten the ability and willingness of market participants to act in the market – an added problem to the increased cost of negative residues. Maintaining the original solution from the draft determination would maintain these unavoidable costs but avoid the added impacts on the market. We believe there is a discrete way to manage CNSP's short-term cashflow concerns without impacting on the operation of the wider financial market.

[25] The AEMC Draft determination, p 10.
[26] The AEMC Draft determination, p 8.

Existing arrangements for IRSR should be maintained for the foreseeable future with further work done prior to any major changes

We would strongly recommend that the AEMC reconsider the approach outlined in the directions paper, until such a time that it can:

- Undertake a comprehensive assessment of the alternative options. We believe the option - proposed by ENA and Transgrid – to establish an AEMO holding fund, would adequately address the TNSP's concerns, whilst maintaining the important value of SRA units.
- Ensure adequate consideration has been given to the feedback of all relevant stakeholders: we note that the AEMC's decision to change its approach following the release of the draft determination was predicated on its own admission that "*While most market participants supported the draft rule as a means to maintain the value of SRA units as hedging instruments once the loop commences operation, CNSPs and some consumer groups noted that the draft rule would still result in significant risks*"[27]. We believe greater discussion with market participants, alongside additional analysis should be undertaken prior to making a decision that so fundamentally reverses the previously recommended, and most widely supported, approach in the draft determination;
- Monitor the operation and actual IRSR impacts of the PEC loop. The AEMC noted[28] it chose not to undertake further modelling or investigation into the projected impacts of the PEC loop due to the complexities involved and difficulty in obtaining results that were not prone to errors. Given this uncertainty and the potential for unintended consequences, we recommend refraining from substantial changes like the netting off proposal that aim to reduce the potential for negative IRSR.

In the interim, we strongly recommend the AEMC pursue either the proposed solution in the draft determination, or AEMO's original proposal, to allow sufficient time for implementation prior to PEC's operation.

Regarding a future SRA-wide review proposed by the AEMC, we would recommend this be postponed until the AEMC has addressed the above, and the outcomes of the Post 2030 wholesale market settings review have been published.

Thank you for your consideration of Alinta Energy's submission. If you would like to discuss this further, please get in touch with Isidora Stefanovic at isidora.stefanovic@alintaenergy.com.au.

Yours sincerely,

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[27] The AEMC Directions paper, p ii.
[28] The AEMC Directions paper, p 53.