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Dear Anne

AEMC Optional Firm Access, Design and Testing: First Interim Report

AGL thanks the Australian Energy Market Commission (AEMC) for the opportunity to comment on its Optional Firm Access (OFA), Design and Testing: First Interim Report (the Report). AGL notes the significance of the proposals contained within the Report, with regard to their likely market (both physical and financial) and consumer impacts. Because of these impacts, this is undoubtedly the most significant reform proposed to be undertaken in the NEM since market start and it is imperative that it be considered as such.

AGL operates across the energy supply chain and has investments in energy retailing, energy services, coal-fired electricity generation, gas-fired electricity generation, upstream gas extraction and is Australia's largest private owner and operator of renewable energy assets.

AGL considers that OFA is an economically elegant solution which would, in a theoretical NEM environment, enhance the efficiency of the market through the provision of clear locational signals, reducing congestion and disorderly bidding as well as providing real economic incentives (through the firm access standard rewards and penalties mechanism) on transmission network service providers (TNSPs). Ultimately, such an outcome can only be of benefit to end use customers.

In reality however, AGL does not consider that the OFA will actually deliver these benefits, and may actually negatively impact the NEM, because of the following reasons:

- **Locational signals**

The provision of a location signal for new entrant generation capacity is an objective that could potentially reduce network expenditure, which would ultimately have a positive impact on end use customer bills. However, the benefits of a locational signal are questionable in a declining demand market – no new investment is required in the NEM for at least another decade.

Further, the OFA model cannot account for other regulatory measures that may impede a new entrant generator from locating in an economically ideal place –

from a spare network capacity perspective – such as the Victorian 2km wind farm set back rule.

Locational decision making is also likely to be significantly impacted by a range of other factors including, for example, wind, water, insolation and fuel availability. Factors which may constrain economically efficient locational decision making activity. In the event that a new entrant is required to locate where there is insufficient existing spare capacity in the market, possibly due to issues identified above, the new entrant will be set a much higher project capital cost to enter in relation to incumbent generators.

Finally, the proposed sculpting of existing access to the network also requires all incumbents to pay for access without any ability to relocate to take advantage of possible access price differences elsewhere in the market.

- **Congestion management and disorderly bidding**

A key benefit of the OFA is stated as being the impacts it would have on the market in relation to congestion management and disorderly bidding. However, the possibility of delivering on these objectives have been brought into question by the Australian Energy Market Operator's (AEMO) Optional Firm Access First Interim Report, as follows:

It is generally assumed that the incentives created by access settlement will encourage generators to offer in a more cost reflective manner during periods of network congestion, and thereby result in more efficient and predictable dispatch. AEMO has reviewed recent events of non-cost-reflective offers in order to test this hypothesis. In each of these events, generator behaviours were also affected by a number of market design and structural issues which are outside of the scope access settlement. It will be difficult to identify the incremental benefits that arise from access settlement alone.¹

It is of concern to AGL that AEMO, in its role of modelling access settlement outcomes, is unable to clearly demonstrate the benefits of OFA.

- **TNSP incentives**

The proposed Firm Access Standard (FAS) will provide greater certainty between the TNSP and generators (both firm and non-firm). Specifically from a financial transaction perspective, as opposed to physical dispatch certainty – as uncertainty will still remain with regard to network carrying capacity at any single point in time (firm access is never really firm).

However, forcing TNSPs to meet a FAS – in order to avoid any associated penalties – may necessitate ongoing investment by TNSPs in assets and infrastructure that are, increasingly, underutilised. The AEMC must ensure that TNSPs are not forced into this predicament.

Further, there is an economic level of congestion even in a perfect network. There is a real risk that OFA will lead to uneconomic overbuild of network capacity as individual generators (and risk departments) are not prepared to accept possibility of having a large number of MW they know could get constrained off and hence unable to earn revenue.

¹ AEMO Optional Firm Access First Interim Report 2014. Available at: <http://www.aemo.com.au/Electricity/Market-Operations/Optional-Firm-Access>

Additionally, network expansion under the OFA may create free-riders in the event that new network infrastructure built is above that needed in the short-term. The current OFA design does not have a mechanism to prevent lumpy over-investment from occurring and any network over-development costs will eventually be passed on to end use customers (increasing their costs) and also leading to the possibility of free riding on the back of the over investment.

- **Financial market impacts**

In addition to the points outlined above, the shift to nodal pricing – implicit in the OFA model – may create financial instability as participants grapple with the changes to existing market settings and attempt to hedge load in the presence of both a nodal price and a regional reference price (in addition to managing access rights between the physical generation capacity and load). Inherent in this is the real possibility that the additional complexity manifests itself into higher risk premiums sought in the contracts market. Should this outcome eventuate it will only lead to increased costs which will eventually be passed on to end use customers.

From an implementation perspective, AGL also questions how the existing SRA mechanism will be folded into OFA.

AGL also notes the merit of the argument that the OFA model is inherently complex. Whilst complexity should not be the sole rationale against pursuing the OFA – it does stretch the capability of policy makers in mitigating possible detrimental market impacts in advance of implementation. An example is the proposal that firm access payments be received by a firm access generator even in the event that the capacity is offline. Has the AEMC considered the extent to which this is a workable option, what incentives it creates for generators holding firm access and whether it may dilute access trading market liquidity?

Furthermore, having to buy access will likely exacerbate the ‘missing money’ problem for incumbent generators - this term relates to inadequate returns to investors in generation capacity (further detail on this is provided in AGL Working Paper No.38, *What is normal profit for power generation?*²). The missing money problem will arise due to the fact that purchasing access increases generator fixed costs, which either results in higher contract prices (especially Caps) or generators being unable to recover the access cost due to oversupply of low variable cost generation capacity suppressing the spot price.

In conclusion, because of the issues raised above, AGL does not support the OFA model and recommends that the AEMC conclude in its 2nd Interim Report (to be released November 2014) that this matter not be progressed further.

Please do not hesitate to contact me on (03) 8633 6967 in relation to this submission.

Yours sincerely



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² Simshauser, P, and Ariyaratnam, J, 2013 Working Paper No. 38 *What is normal profit for power generation?*. Available at: <http://www.aglblog.com.au/wp-content/uploads/2013/09/No.38-Normal-Profit.pdf>