



EnergyAustralia

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Dear Commissioners

Lodged electronically: www.aemc.gov.au (EPR0039)

Optional Firm Access, Design and Testing: First Interim Report

EnergyAustralia welcomes the opportunity to make a submission on the 'Optional Firm Access, Design and Testing' first interim report (*the report*). We also thank the Commission for the opportunity to participate in the OFA working group and present at the public forum on the report¹.

EnergyAustralia is one of the country's leading retailers, providing gas and electricity to more than 2.7 million customers. We own and operate a range of generation and storage facilities, including coal, gas and wind assets, in NSW, Victoria and South Australia.

We understand that the AEMC intends to publish its draft recommendation on whether or not optional firm access should be implemented in November. This is the threshold issue. We consider the analysis to date is sufficient to support the recommendation that OFA should not be implemented.

Implementation of OFA would be complex and costly. The prospect of unintended consequences is high given the extent of fundamental change required. Full implementation will take over a decade to complete and create protracted uncertainty. Additionally many of the issues that have arisen in the technical design stage are proving intractable.

We recognise that the OFA design may offer some theoretical benefits at the margin. However, we are unable to identify a core problem that OFA solves and that would deliver the material net benefit needed to justify such complex and costly reform. OFA will not materially improve dispatch certainty for generation or interregional hedging, and AEMO has been unable to identify any material dispatch efficiency benefits to date². The multiple exceptions identified as necessary in prototype testing will also undermine the coherence of any access settlement design.

¹ <http://www.aemc.gov.au/getattachment/494f4ba0-ddf2-4e87-b44f-ea43b1b44afd/Ralph-Griffiths-%E2%80%93-EnergyAustralia.aspx>

² <http://www.aemo.com.au/Electricity/Market-Operations/Optional-Firm-Access>

We are particularly concerned that the incorporation of simplistic and misleading aged-based asset lives in the LRIC pricing model, and implicit recognition of 'scale efficient network extensions', would lead to inefficient over investment.

There are simpler ways to improve location signals and long term certainty for generation investment through the transmission planning domain.

We acknowledge that circumstances have changed since OFA was first proposed. Demand has fallen and the NEM is now chronically over supplied. For the first time in NEM history, AEMO's forecasts suggest that no new generation capacity is required in any region for the next 10 years³. Falling demand is also resulting in reduced need for investment in transmission⁴.

It is reasonable to consider whether it would be worth proceeding with OFA ahead of the need for the reform, particularly given the long lead time. However, many OFA design elements are partial or inconsistent and likely to be subject to change over time negating any benefit of early implementation. For example:

- OFA creates a nodal market for generation, while maintaining a regional market for load. This would introduce a new and unstable distortion between the demand and supply sides of the market. The Productivity Commission has already recommended OFA be reviewed in favour of nodal pricing within 10 years⁵.
- One objective of OFA is to provide a more commercial framework for transmission planning. However, the regulated LRIC pricing methodology ensures the TNSP's plan is central to access pricing and the firmness of access will be determined by the AER in setting TNSP incentives. OFA may render generation investment more subject to regulatory central planning, rather than make transmission planning more commercial.
- OFA creates 'financial rights' but ties them to physical generation availability, and potentially to physical transmission assets. This structure is incoherent and has been subject to change with each iteration of the OFA design to date.
- OFA has the potential to expose non-firm generators to local marginal prices that are significantly lower than the current market floor price due to geared participant factors, or alternatively require dilution of the firmness of 'firm access'.
- The OFA framework will introduce an unresolved queuing issue for bilateral negotiations between a generator and a TNSP.

We appreciate the rigor and independence with which the AEMC, and AEMO, have approached the detailed design of the OFA. This work has been instrumental in exposing the limitations of the design.

We support the Commission's recognition that it is in the long term interests of consumers to implement appropriate transitional arrangements for electricity investors whenever there are significant regulatory changes. The NEM is a facilitated market established through regulatory fiat and this principle is critical to every current and future investor in the market.

³ <http://www.aemo.com.au/Electricity/Planning/Electricity-Statement-of-Opportunities>

⁴ <http://www.aemo.com.au/Electricity/Planning/National-Transmission-Network-Development-Plan>

⁵ The Productivity Commission in their Electricity Network Regulatory Frameworks Inquiry Report (Vol 1, April 2013) want a review after 10 years of OFA to assess nodal pricing. http://www.pc.gov.au/_data/assets/pdf_file/0016/123037/electricity-volume1.pdf

In relation to the specific issues raised in the paper we would like to highlight the following.

Assessment framework

We support the proposed assessment framework. However, when we assess the OFA design against the framework we find it lacking. The table below shows our indicative ranking of the importance of each element and whether OFA would improve on the status quo.

Category	Importance	Improvement
Financial certainty for generation		?
Effective inter-regional hedging		?
Efficient operation of network		
Efficient dispatch of generation		?
Trade-off operation and investment		
Efficient investment network capacity		
Efficient investment generation		
Efficient allocation risk		
Transaction costs		X

Question marks indicate that we can identify significant risks, but not the claimed benefits.

We do not think OFA would provide improved financial certainty or more effective inter-regional hedging. Generators do not price congestion risk separately in contracting; this is a small factor relative to forced outage risk. Access settlement is complex and introduces new risks. There are no significant benefits in access settlement as a standalone element.

OFA may provide more efficient long term signals for transmission and generation investment, through the published LRIC pricing, however generators already face a location signal to minimise congestion risk and loss factors. The LRIC model's deterministic design and focus on physical assets may increase the risk that generators, and/or customers, will be required to fund excessive underutilised capacity.

Firm access standard and TNSP incentive scheme

A transparent and binding planning standard supported by an incentive scheme would be necessary under OFA to incentivise TNSPs to efficiently plan, build and operate the network to deliver the contracted firm access service. The design of TNSP incentives should focus on efficient delivery of the firm service to rights holders, rather than the delivery and operation of physical transmission assets. A probabilistic standard would be more efficient than the deterministic standard implied in the report.

We support the current proposal for a standard that applies at all times and agree that the incentive scheme should be low powered, providing incentives for the TNSP to plan and operate the network to deliver the agreed level of firm access efficiently. The incentive should reflect the efficient cost of providing the service. An incentive linked to the potential benefit to generators may create incentives for TNSPs to over-price or 'gold plate' access.

Under an OFA regime, generators will buy a firm access service. This service should be delivered at the most efficient cost. The current design focuses on incentives for the delivery of physical assets. The focus needs to shift to incentivising the efficient delivery of the firm service, which may involve a mix of operational and capital expenditure.

Inter-regional access

Inter-regional firm access is one of the more complex and ambiguous elements of OFA. We agree that there would be benefit in facilitating more effective hedging between regions. However, the OFA model does not deliver a fully firm inter-regional hedge and the benefits of the 'firmer' access would be marginal. While inter-regional firm access reduces volume risk, it would create basis risk.

We also recognise that incentives to rebid under OFA may be reduced and this should theoretically improve interconnector firmness, however regional pricing incentives are only one of many reasons why offers away from costs occur and therefore we do not expect significant improvement in inter-regional firmness solely through OFA.

In preference to proceeding with OFA, we would support a more targeted review of options to improve the design and operation of the existing settlement residue auctions.

Short-term firm access

The distinction between long and short term access in the current OFA design may be relevant for the TNSP, the regulator and the design of the TNSP incentive scheme.

However, from the perspective of generators, the distinction between short and long term access is artificial and undesirable. Generators would like the ability to purchase firm access services for a variety of tenors. The majority of forward contracting in the NEM occurs within a three year horizon, and we would anticipate the majority of liquidity in the firm access market would align with this.

The creation of a market in firm access rights would provide a price signal to inform the value of future augmentations. TNSPs should be in a position to coordinate multiple parties to help underwrite augmentations and be allowed to hold new long term access rights for future sale subject to assessment under a modified RIT-T. Holding long term firm access rights arising from customer funded augmentations on the TNSP's balance sheet may reduce the cost to consumers due to the TNSP's lower cost of capital.

Transitional access

The NEM is a facilitated market created through regulation. Participants must be able to invest in the NEM with the reasonable expectation that they will not be stranded by future changes to the core regulatory design. It is almost impossible to invest in a regulated market without this expectation. Exposing investors to significant unforeseeable regulatory risk, particularly in a facilitated market, must impact confidence and increase the cost of future investment.

We strongly agree with the Commission that it is in the long term interests of consumers that there is appropriate transition for investors in the NEM whenever there are significant regulatory changes, and that this may need to include consideration of the balance sheet impact on individual participants.

All existing generation investments were made on the basis of an open access transmission system, and the implicit level of access associated with this regime for specific locations. Allocating firm access rights consistent with the existing level of implicit firm access is the simplest and most effective way to recognise existing rights and keep investors whole. The allocation method should be technology neutral and fair to all participants.

This approach will benefit all current and future investors. Current investors will not be stranded and future investors can have confidence in the stability of the regulatory arrangements that underpin the market design.

Allocation of the existing firm access capacity of the transmission network will not reduce the efficiency of the reform. All NEM generators are by necessity sophisticated and informed traders. Trading will ensure the rights are allocated through the market to those who value them most. There is no rationale for sculpting to achieve this outcome. What is both necessary and sufficient is to create an effective process to allow rights to be converted from one location to another and a platform to facilitate matching buyers and sellers.

The only rationale for sculpting is to match the potential for a slow degradation of the physical firm access capability across the transmission network.

Staged implementation

The NEM is a single wholesale market. Implementing OFA at different times in different regions is unacceptable.

Access settlement by itself provides no material benefit, but creates significant new risks. A staged implementation where access settlement is introduced ahead of the full OFA model would be inappropriate.

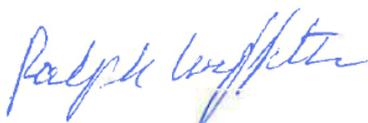
If OFA is to be implemented, it should be implemented across the NEM in one coherent reform, based on a comprehensive plan after all governance arrangements, roles, auction processes, pricing models and other requirements have been finalised. The ten year implementation timetable needed to align with TNSP access determinations is too long and would create an unacceptable level of uncertainty for investors during the period. Therefore the consideration of OFA implementation cost should include the costs and risks of implementing within transmission access periods, or reopening the determinations.

Conclusion

In summary we consider the analysis to date is sufficient to recommend that OFA should not be implemented. The AEMC should recommend to the COAG Energy Council that this work stream end after the second interim report and therefore avoid intricate detailed system design and rule change drafting. The case that OFA is likely to provide substantive improvement or efficiency gains has not been made and it is unlikely to eventuate.

For any questions regarding this submission, please contact me on (03)86281034.

Regards



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