



Department of State Development, Business and Innovation

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Mr John Pierce
Chairman
Australian Energy Market Commission
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Dear Mr Pierce

The Department of State Development Business and Innovation as the portfolio agency with responsibility for energy matters in Victoria is pleased to make the attached submission in response to the First Interim Report: Optional Firm Access, Design and Testing.

Questions about the Department's submission can be directed to Mr Greg McLeish, Principal Policy Officer who can be contacted by phone at (03) 9092 1895 or by email at gregory.mcleish@dsdbi.vic.gov.au.

Yours sincerely

Mark Feather
Executive Director
Energy Sector Development Branch

23 / 9 / 14.

Department of State Development Business and Innovation

Submission in Response to the Australian Energy Market Commission First Interim Report:

Optional Firm Access, Design and Testing: July 2014

Introduction

The Department of State Development Business and Innovation (DSDBI) supports in principle the introduction of a system of market based firm access rights through the Optional Firm Access model.

DSDBI considers that there is significant uncertainty with respect to future patterns of generation in the National Electricity Market, including uncertainty over the size, nature (e.g. fuel type/renewable source) and location of generation in the market. This uncertainty is driven by a number of factors including climate change policy, technological change (e.g. increasing take up of cheaper small scale decentralised generation such as solar power, and potential take up of electric vehicles and storage products) and other factors including falling demand for electricity.

It is therefore important that the transmission planning and investment framework is sufficiently flexible to take into account a range of different futures so that investment in generation occurs in the most efficient locations.

Under the current commercial and regulatory arrangements, transmission planning is undertaken on a centralised basis by an independent planner, AEMO. Whilst this framework has served Victorian consumers well, the risks around inefficient over or under investment in transmission remain primarily with consumers.

DSDBI considers that the risks of inefficient under or over investment are particularly material at a time of significant market uncertainty as to future generation patterns in the NEM. Under investment in the network may prevent efficient lower priced generators being dispatched and may increase costs to consumers as well as creating security of supply risks. Conversely, over investment in the transmission network is likely to be inefficient and will result in unnecessary costs being imposed on consumers. There is therefore scope to improve investment signals for generators and efficiently allocate the risks associated with transmission investments.

As such, DSDBI is supportive of a market based framework such as OFA under which generators enter into financially firm access arrangements that provide signals for future transmission investment and through which generators can be compensated if their output is reduced through transmission network congestion. Under this model, risks associated with the size and location of future generation led transmission investments are moved away from consumers and allocated primarily to generators. DSDBI considers that it is generators who are best placed to manage these risks.

DSDBI considers that the OFA arrangements should help to ensure that transmission investment is delivered in a timely manner and at the right locations. In turn, this will ensure that consumers are paying no more than is necessary for the delivery of efficient and reliable transmission services. This is critical at a time of significant uncertainty in the market as to the future timing and location of incremental transmission investment.

Related to this, DSDBI also considers that it is critical that adequate incentives are placed on transmission service providers to ensure that they respond efficiently to market based signals, both in terms of network investment and operation. In the absence of effective incentive arrangements and increased risk and reward for TNSPs, there is a significant risk that the arrangements may not deliver benefits to consumers.

With this background in mind, DSDBI offers the following comments on the AEMC's interim report.

Assessment Framework

DSDBI is broadly supportive of the assessment framework and assessment categories adopted by the AEMC in Chapter 3 of the First Interim Report. DSDBI suggests that there are potentially three additional assessment categories that could be included in the framework.

These categories are:

- Wholesale and retail market competition
- Security of supply
- Market transparency

Whilst Chapter 3 discusses the potential benefits of the OFA model in enhancing competition between generators and competition between retailers, it is recommended that competition be included as a separate category, given the direct benefits that enhanced competition provides for consumers. For example, by providing enhanced inter-regional hedging, the OFA arrangements may increase the ability of generators to contract across regions. This should improve the ability of retailers (particularly non-vertically integrated retailers) to access a broader range of generator contracts, thereby enhancing retail competition. Increased wholesale and retail competition is an important driver of efficiency and consumer benefits and should therefore be recognised in a separate category.

Similarly, to the extent that OFA provides enhanced transmission investment signals, this should promote efficient network investment which in turn promotes security of electricity supplies to customers over the medium to long term by ensuring that investment is occurring in the right place and at the right time.

Lastly, it is expected that the OFA regime should deliver enhanced market transparency around price and availability of inter and intra-regional access, including through longer term OFA based agreements, inter-regional access and short term firm access. The development

of these trading arrangements should enhance price discovery and promote competition in wholesale and retail markets for the long term benefit of consumers.

DSDBI also notes that the AEMC intends to quantify the positive and negative impacts of OFA under each of the categories it has suggested. In Chapter 3 the AEMC notes that such quantification will be difficult in some cases and may exhibit a large range of uncertainty and that in some instances qualitative issues may be more important than quantitative issues. DSDBI agrees with the AEMC on this and notes that in undertaking any cost benefit analysis it is inherently easier to measure transaction costs whilst it is harder to measure factors such as competition benefits.

DSDBI would therefore caution the AEMC from providing disproportionate weight to transaction cost measurements in comparing these with harder to measure longer term efficiency benefits associated with factors such as increased competition, and efficiency in network investment and operation.

DSDBI also agrees that it is important that the AEMC's assessment occur across a broad range of future scenarios, including scenarios where generation becomes increasingly decentralised. This should include an assessment of whether there are benefits in progressing with OFA under such a scenario.

Conversely, DSDBI also considers that an assessment should also consider other factors including future investment in remotely located wind generation as well as the potential take up of electric vehicles and the impact that this might have on overall electricity demand and future baseload generation.

The Firm Access Planning Standard

In Chapter 4 of the First Interim Report, the AEMC has proposed the introduction of a Firm Access Planning Standard. This is a mandatory standard that requires a TNSP to plan its network so as to be able to provide agreed access levels for firm generators under a set of specified conditions. Importantly, the AEMC indicates that the standard would specify "the level of redundancy that TNSPs must build into their network". The AEMC notes that the development of this standard would take into account generator access agreements and the value that generators place on access.

DSDBI is concerned that the introduction of a standard that requires the TNSP to invest to meet the standard may not encourage efficient investment decisions. For example, DSDBI considers that in some instances it may be possible for TNSPs to deliver a physically firm service through efficient and innovative network operation as opposed to investment. In this context, any OFA framework should encourage a TNSP to make efficient trade-offs between network investment expenditure and operational expenditure. However, by requiring a TNSP to invest to a redundancy based standard, the option for these efficient trade-offs is removed, potentially to the detriment of consumers.

DSDBI also notes that in considering whether to invest in response to an OFA based agreement, it is possible that changes in demand elsewhere in the network make the

requirement to invest unnecessary. For example, if demand decreases in an area affected by an OFA, it may be the case that the TNSP could deliver firm access by utilising its existing network capability rather than investing.

DSDBI therefore has material concerns that any requirement on TNSPs to invest to meet a redundancy based standard may lead to inefficient levels of over investment.

DSDBI considers that it may be preferable to adopt an output measures approach under which output measures are established that reflect existing peak network capacity levels, with these outputs being subject to increments to reflect any Optional Firm Access agreements that a TNSP enters into for new network investment.

Under an output based framework, it would be up to the TNSP to determine how the level of outputs it is obligated to provide is actually delivered, rather than binding the TNSP to an investment solution.

The Report notes that there may be difficulties in proving whether a TNSP has met the firm access planning standard. It suggests that the Australian Energy Regulator (AER) be tasked with assessing if a TNSP has met the standard and that failure to meet the standard would be deemed a breach of the National Electricity Rules and possibly a conduct provision that would allow a "person other than the AER" to recover losses or damages arising from the breach of the Rules. On this basis it is suggested that the OFA design could place a greater weight on financial incentives to ensure that TNSP's provide an appropriate level of firm capacity.

It is possible, however, that a TNSP may enter into an OFA contract to provide a quantity of firm access to a generator, but simply fail to take any action to make the additional firm capacity available or fail to do so in the required time. In these circumstances it may be appropriate to require the TNSP to buy back the level of capacity it has not delivered. Such a buy back arrangement would operate as an incentive on the TNSP to deliver the incremental additional capacity in a timely manner, but would be separate from any operational incentive to support the efficient management of planned and unplanned outages.

It is accepted that the approach being proposed by DSDBI blurs the distinction between long term and short term firm access as long term access would no longer be explicitly linked to additional physical capacity. Our view is that this is consistent with OFA essentially being a financial product.

Generator credit arrangements

DSDBI notes that the ability of the OFA framework to deliver effective investment signals from generators will depend in part on the nature of the credit arrangements that generators would need to post when entering into an OFA. If these credit arrangements are weak, there is a risk that a generation business may enter into an OFA agreement which in turn drives incremental network expenditure, only for the generator to subsequently pull out of the agreement. This creates a risk that consumers would have to bear the cost in any short fall of revenue associated with the failure of the generator to discharge its obligations under the

OFA agreement. It is important that the AEMC work towards ensuring that any OFA arrangements are supported by appropriate credit provisions.

The Operational Incentive Scheme

DSDBI supports the proposal to apply the operational incentive scheme at all times. As a consequence OFA will provide a firmer but not completely firm access right. As noted above if the AEMC's proposed approach to OFA were modified to accommodate DSDBI's concerns about the proposed firm access planning standard, the operational incentive scheme would have a stronger role in incentivising TSNP's to provide the required level of firm access and could not be as low powered as the operational incentive scheme proposed by the in the Report.

DSDBI is otherwise broadly supportive of the incentive framework that has been proposed by the AEMC and recognises the benefits of applying tools such as nested caps and collars to limit risks associated with particular events and at the same time ensure that the incentives continue over time.

DSDBI, however, believes that consideration should be given to whether the incentive regime should be supported by legal obligations (potentially in the National Electricity Rules) to ensure that TNSPs operate their respective systems in an efficient manner. In particular, to the extent that a TNSP reaches its exposure cap (either the nested caps or the overall annual cap) it will remain important to ensure that the TNSP retains an obligation to operate in an efficient manner once the incentive is no longer in operation. Such an obligation would be enforceable by the Australian Energy Regulator.

Transitional Access

As the introduction of OFA would represent a major change in NEM design, DSDBI supports the development of transitional arrangements that will allow generators and other market participants' time to adjust. However, a number of considerations suggest that the adjustment period should be of limited duration with a rapid and complete scaling back of transitional access:

- as the Interim Report notes, a significant amount of time would have elapsed between the proposal to introduce OFA in the Transmission Frameworks Review and its final implementation so that market participants would have ample time to prepare;
- the proposed initial allocation of transitional OFA would provide generators with the level of firm access that they implicitly receive at present, subject to achievement of the proposed firm access planning standard. However, the introduction of OFA in itself will provide generators and other participants with a new mechanism through which to manage congestion risk, so it is not clear why a transitional mechanism is needed; and
- the proposed initial allocation of transitional access results in only a small amount of capacity being available to back the purchase of firm interconnector rights. Even with efficient secondary trading in OFA, parties wishing to purchase firm interconnector rights would not be able to buy transitional access and convert this into firm interconnector rights until transitional access is scaled back.

DSDBI also does not support the proposal to allocate a residual amount of OFA to existing generators based on projected plant life. Experience with current generation assets indicates that with maintenance and refurbishment these assets can have very long lives so that a decision to close a generator is more likely to be due to market conditions as much as plant condition. Consequently projected plant lives are likely to be largely arbitrary. In addition, existing generators allocated a residual amount of OFA for assumed plant life are likely to sell their OFA during the closure process. As the generators would not have purchased this transitional OFA, there would appear to be no case for allowing them to potentially obtain a "windfall gain" at closure.