Draft Rule Determination: Five Minute Settlement Rule 2017 (ERC0201)

Alinta Energy

Submission

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1. *Introduction*

Alinta Energy (**Alinta**) welcomes the opportunity to provide a submission to the Australian Energy Market Commission's (**AEMC**) *National Electricity Amendment (Five Minute Settlement) Rule 2017* Draft Determination.

Alinta is both a generator and retailer of electricity and gas in the east and west coast energy markets. It has an owned and contracted generation portfolio of 1957MW, including 1700MW of gas-fired generation facilities, and in excess of 800,000 customers including more than 250,000 in east coast markets. As an active and growing market participant Alinta expects to be directly impacted by the implementation of the five minute settlement rule change.

After careful consideration of the five minute settlement debate to date, on balance Alinta agrees with the underlying proposition that aligning the settlement and dispatch intervals within the National Electricity Market (**NEM**) will allow for more economically efficient outcomes for the market and consumers in the *long run*.

However, the implementation of five minute settlement represents a fundamental change to the existing wholesale market arrangements in both the spot and hedge markets. As such, it is critical the AEMC pragmatically manages the short term impacts of five minute settlement appropriately. This is especially true given the current transformative and sometimes volatile market conditions the NEM is experiencing.

Alinta is of the view that the current proposed transition period of three years and seven months runs the risk of inviting unforseen risks into play at a precise time when the NEM is already under duress and is experiencing significant change.

As such, Alinta recommends that a five minute settlement transition period of four years and seven months (**1 July 2022**) be adopted. This timeframe is required to appropriately manage the unprecedented workload of market reforms which will arise from this rule change, as well as to help mitigate unforeseen risks. The rationale for this position is further explored below.

2. *Alinta's key issues*

2.1 System Readiness

As an active user of NEM trading systems, settlement systems, forecasting tools and wide array of other associated brokering products, Alinta's systems will be directly affected by the implementation of five minute settlement and will subsequently require substantial upgrading.

Initial analysis highlights that the costs of such upgrades will be substantial and will potentially span a lengthy time period. On this point it is also worth noting that:

- Development and modification of NEM trading and settlement systems is a relatively niche industry, and there are relatively few firms offering these services to market.

- Participants are not able to access "off the shelf" energy trading and settlement systems to allow for five minute settlement. Energy trading and settlement systems contain tailored and bespoke elements which vary substantially from participant to participant according to individual engineering conditions, IT security, and specific generation plant type.

- Demand for energy systems upgrades will not just come from market participants who hold a physical position, but also the ASX, a wide array of brokers, the Australian Energy Market Operator (**AEMO**), the Australian Energy Regulator (**AER**), banking institutions and likely many others.

- The implementation of five minute settlement is a regulatory obligation, which guarantees a healthy pipeline of work to energy trading system firms. Given the short time frame, this will potentially lead to scarcity pricing arising (which ultimately will be passed on in the form of higher prices).

- The designing, building, testing and operationalising of energy systems which can comply with five minute settlement will require significant time and internal human resources from participants. Following a successful build, participants will additionally need ample time to ensure their trading systems can indeed link and connect with AEMO's systems.

Alinta considers that its proposed transition period of 1 July 2022 would go some way to mitigate price scarcity arising, and thus help ensure uneconomic outcomes are minimised. Additionally, a longer transition period would give participants an appropriate lead time to undertake the not-insignificant task of designing, building, testing and operationalising what is the biggest wholesale market IT systems upgrade the NEM has experienced in recent memory.

2.1 System Readiness - Test Environment

The AEMC has correctly identified that AEMO will need to provide a shadow test environment for participants to trial five minute bidding and five minute settlement.

Alinta is highly supportive of this objective and notes a similar and successful test environment was established with the entry of the Wallumbilla gas hub in 2014 by platform provider Trayport, which spanned a month trial period.

Given the significant market implications for the NEM under five minute settlement, Alinta suggests any test environment established by AEMO should span six – twelve months at a minimum, and crucially should run over an entire summer period. A long trial time is necessary to allow market participants to test effective operations, wholesale strategies, settlement compliance processes, prudential operations and to more broadly monitor the performance of the NEM as a whole.

Alinta's proposed transition period of 1 July 2022 will allow AEMO, market participants, brokers, regulators and market observers the necessary time to establish, test and monitor the shadow NEM wholesale market environment, in what is a critical piece of work underpinning the NEM wholesale market.

2.2 System Readiness - Regulatory Prerequisites

Throughout the consultation process, many participants noted the benefits of five minute settlement will only arise with simultaneous regulatory and procedural changes throughout the NEM. This includes ASX processes/products, AFMA processes, banking/brokered products, AEMO settlement processes and many others.

Whilst each required procedural change may only appear relatively minor in nature, as a collective all of these regulatory changes are material. It is worth noting that these regulatory changes are in addition to the unprecedented amount of other competing regulatory reforms[1] currently being undertaken within the industry from various regulatory and governance bodies.

Implementing what is widely regarded as the most fundamental change the wholesale market has experienced in recent memory, under a tight-time frame for implementation runs the risk that fairly innocuous and seemingly insignificant errors may pass the attention of market participants and regulators, potentially creating distortions in the future.

Alinta is of the view that a start date of 1 July 2022 will assist in somewhat lessening the significant regulatory burden arising from the implementation of five minute settlement (in conjunction with implementing the myriad of other reforms currently underway). The extended time frame will also ensure a controlled approach can be undertaken to give appropriate due consideration to reforms to mitigate the risk of implementation errors arising.

3 Contractual Implications

The AEMC[2] correctly noted in its directions paper, that there are significant contractual implications associated with the transition to five minute settlement:

> "*The potential contract market disruption from a move to five minute settlement is of particular concern to the Commission. The contract market plays a crucial role in that it reduces price uncertainty for generators, retailers, major industry and consumers of electricity. It allows generators to manage risk, secure finance and provides signals for on-going investment in generation capacity. For retailers, it provides for security of supply to deliver price stability for consumers, and allows them to secure financing for their own operations. Given the importance of liquidity in the contract market, it is vital that disruption to this market is minimised.*"

Alinta agrees with the AEMCs sentiments above, and expects to be directly affected in the following manner in regards to contractual implications:

- Alinta (along with the vast majority of market participants) is currently a counterparty to cap contacts which extend beyond the proposed five minute settlement start date of 1 July 2021. These contracts will require re-negotiation and/or the potential triggering of market disruption clauses.

[1] Just to illustrate the scale of the workload currently being undertaken the NEM, it is worth noting a cut down list of market reviews/reforms the market is working on presently: Distribution Market Model (AEMC), SRAS guidelines update (AEMO), Suitability of day ahead market (AEMC/Finkel), Generator Reliability obligation (Finkel), Retail electricity price inquiry (ACCC), Wholesale Market Monitoring power (AER), Retail Competition Review (AEMC), Strategic Priorities (AEMC), Minimum Inertia Levels (AEMO), Strategic Reserve Market (Finkel/AEMO), various state based renewable schemes and reforms, and the list goes on.

[2] AEMC, Five Minute Settlement - Directions Paper, page iii, (2017)

- If market disruption clauses are indeed triggered, one-off wealth transfers may arise and subsequent costly and lengthy legal disputes may arise between market participants and their counterparties.

- The majority of Power Purchase Agreements between wind farm developers and retailers extend well beyond 2021, with some going out as far as 2030 (the end of the Renewable Energy Target). If market disruption clauses are indeed triggered, these agreements will also have to be renegotiated or potentially would up early.

- There are a wide array of minor and secondary contracts and internal operational procedures which make reference to settlement periods, which subsequently must be reviewed (and potentially amended) by Market Participant's internal legal teams and/ or external lawyers.

Following the AEMC's draft determination the industry has come to terms with the fact that five minute settlement will be implemented at some stage in the near future and some level of contractual disruption is now inevitable. As such, the question now becomes: how best to appropriately manage the significant contractual disruption and associated issues which may arise following implementation?

Given this is a somewhat untested legal area and with no comparable precedent in the NEM, on balance Alinta considers that the current proposed implementation date of 1 July 2021 does not allow sufficient time to resolve issues in a structured and well thought out manner, and importantly doesn't allow for sufficient time for potential legal disputes to be resolved. Noting this, lengthy procedural measures are necessary to ensure legal certainty for all parties and to allow sufficient time to consider and resolve associated issues.

Alinta strongly considers that the AEMC should not unduly hasten what is the largest market reform the NEM has experienced, by wedding itself to a 1 July 2021 start date. On balance, Alinta's proposed five minute settlement start date of 1 July 2022 appears preferable to allow the NEM sufficient time to resolve contractual issues and for any potential disputes to be concluded.

4 Alternative Risk Management Products

Throughout the consultation process it has been well acknowledged by stakeholders and the AEMC that five minute settlement will significantly reduce the amount of over the counter (**OTC**) cap contracts being offered in the NEM.

Nonetheless, the AEMC's view is that under five minute settlement incentives will still exist for the creation of alternative risk management products. Whilst Alinta agrees with this view, it is unclear how long it will take for these alternative products to be developed, and even once a preferred alternative product has indeed been established it may take several years for ample liquidity to exist enough for market participants to sufficiently call upon it with confidence.

As such, there is a real possibility that post the implementation of five minute settlement in the NEM, an illiquid and likely expensive cap contract styled market will arise until new generation plant capable of responding within five minutes is procured, or until there is sufficient means for market participants to purchase alternative hedge products. At present, it appears unlikely that either of these conditions will exist by 1 July 2021 at the scale required to minimise risk in the NEM.

Whilst Alinta's proposed 1 July 2022 start date does not guarantee the creation of an alternative market recognised hedge product, this extended timeframe does give the industry some additional time to further explore and refine potential options/products to help fill the gap left by the rapid removal of OTC cap contracts.

For example, one option canvassed by industry is for future cap contracts to be potentially based on a 30 minute average of five minute periods. Alinta would be supportive of the AEMC's final rule change dedicating appropriate consideration to exploring this and other potential alternative risk management products.

Alinta has confidence that the market will sufficiently adapt to the changing environment given ample time. However a well-functioning, liquid and contractually secure hedge market will take significant time to develop. Alinta considers that the proposed 1 July 2021 implementation date could increase the risk to the NEM through participant's being unable to secure sufficient and non-cost prohibitive risk management products.

Alinta considers that its proposed 1 July 2022 transition period would go some way to mitigating this risk by allowing appropriate time for industry led investigation, design, testing, and ideally potential trading of alternative hedge products, before the implementation of five minute settlement.

5 Conclusion

Alinta is supportive of the underlying economic premise of aligning the settlement and dispatch intervals of the NEM, and considers it an important next-step in the evolution and maturity of the market in the long run

Nonetheless, Alinta's recommendation for a longer transition period of four years and seven months is recognition that the benefits of the five minute settlement are still somewhat theoretical and ambiguous over the short term. The costs however are tangible and real. Given this, a sensible and pragmatic transition period through to 1 July 2022 is more preferable in order to manage the transition to five minute settlement in a robust and secure manner.

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Yours Sincerely

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