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Wednesday, 19 June 2019

Mr Craig Oakeshott
Director, Wholesale Energy Markets
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr Oakeshott

RE: Draft Interim Contracts and Firmness Guideline

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) draft interim Contracts and Firmness Guideline (the Guideline).

About ERM Power

ERM Power is an Australian energy company operating electricity sales, generation and energy solutions businesses. The Company has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load[1]. A growing range of energy solutions products and services are being delivered, including lighting and energy efficiency software and data analytics, to the Company's existing and new customer base. The Company operates 662 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland. www.ermpower.com.au

General Comments

The financial contracts market underpins the operation of the generation and retail markets by providing a risk management tool for both retailers and generators. Broadly speaking, contracts help protect retailers from the risk of high prices and generators against the risk of low prices. The importance of a deep and liquid contract market supported by price discovery is one of the important reasons that the Retailer Reliability Obligation (RRO) moved away from its initial design where retailers would have needed physical contracts for supply.

Under the RRO, the detail of a retailer's contracting book is now essential for compliance purposes if a gap period is declared. For this reason, ERM Power has a strong interest in how the AER will assess the firmness of contracts under the RRO.

Generally, we consider that the AER has taken a sensible approach in the draft interim guideline. We believe that there are improvements that can be made to provide more scope for tailored firmness methodologies while maintaining a rigorous compliance process. Given that this is an interim guideline, we also believe that the AER should be willing to have an open-minded approach at this stage and allow a reasonable degree of flexibility to assist the industry and itself to learn from the initial operation of the RRO.

[1] Based on ERM Power analysis of latest published financial information.

Caps and swaps

As two of the most common forms of contracts, the fact that the AER has proposed a firmness factor of 1 for swaps is sensible and ensures that the basic building blocks of contracting will be treated fairly. The decision to also allocate caps with a strike price above the usual $300/MWh strike price (up to 5 per cent of the market price cap) a firmness factor of 1 is also a sound proposal.

This will allow for innovation in the space, particularly given the shift to five-minute settlement due on 1 July 2021. The change to five-minute settlement is likely to have an impact on contract markets, especially for cap contracts, so allowing for these products to evolve is a sensible decision in the long-term interest of the market.

ERM Power also agrees with the AER's proposal to give load following contracts a firmness rating of 1 for the buyer subject to any volume or other limitations. The AER's approach to having sellers take on the expected load as a negative value in their contract report is also a logical decision.

Standard vs non-standard contracts

The AER has proposed a basic approach of classifying contracts as either standard or non-standard contracts. We are supportive of how it has differentiated types of contracts into the two categories. We are also broadly supportive of the use of a 'delta value' to define the firmness factor. The delta value is a well-understood and commonly used metric that market participants use now to determine the likelihood of option contracts being exercised. However, we consider that for some contracts, particularly purchased call options, liable entities should have the ability to develop an alternative methodology that is audited as per the normal process for non-standard contacts. These could be classified as 'enhanced standard' or 'audited standard' contracts.

While a standardised approach for options is worthwhile in some cases, particularly for small retailers, there should be an opportunity for liable entities to engage an auditor if they believe the standardised approach does not correctly assess the likely firmness of the contract. If a party chooses to do so, they can instead engage an auditor to assess the firmness using a different methodology provided that it meets the principles of the RRO.

We also note that as part of determining the delta value, the AER argues that liable entities must use the volatility from the closest strike price to the value of the underlying instrument as published by a registered exchange. Yet in our experience as an active financial market participant, we have seen that the volatility that exchanges such as the ASX places on trades can be materially inaccurate. If multiple registered exchanges are publishing volatility values, it is also unclear as to what value should be used. We understand that the ASX is moving to a survey-based assessment of volatility which should help to provide more consistency to the rating of volatility. In a similar vein to the treatment of options, we believe that liable entities should have the ability to have auditors approve an alternative volatility measure if they choose.

Demand response

The AER's approach to demand response is similar to that for other forms of internal allocations. Demand response arrangements that form part of a liable entity's net contract position report will need to be firmness adjusted for factors including the degree of discretion the entity has when calling for demand response, the time taken to respond and the frequency with which load can be curtailed. We consider that the wholesale market trigger price may also be a worthwhile factor to consider. A load that only curtails at the market price cap would presumably be less 'firm' than one that curtails at $1000/MWh for example.

In addition, we note that a the AER's workshop on the Guideline, there was some misunderstanding among participants about the impacts of demand response on the net contract positions and the load considered for compliance purposes. We encourage the AER to include some worked examples in an appendix to the final interim guideline to provide greater clarity.

Conclusion

ERM Power largely agrees with the AER's approach to assessing the firmness of contracts. We consider that the AER should adopt some changes to allow for liable entities to have an agreed audited approach for standard options such as swaptions, captions and average rate options. This should also include an agreed approach to the assessment of volatility. We believe that this will allow entities to retain access to a standard approach if they choose, or to have an auditor assess an alternative methodology if they believe the standard methodology is not suitable.

Please contact me if you would like to discuss this submission further.

Yours sincerely,

[signed]

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