Finncorn

Submission – Draft Interim Qualifying Contracts and Firmness Guideline

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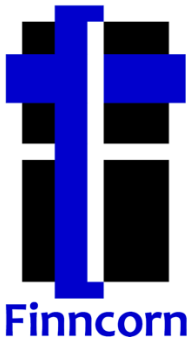

By email: RRO@aer.gov.au

Submission – RRO Qualifying Contracts & Firmness

We provide this short submission in response to AER's May 2019 consultation paper on the Draft Interim Qualifying Contracts and Firmness Guideline under the Retailer Reliability Obligation (the "Guideline"), and following the associated workshop. It is suitable for public release.

Summary and recommendations

Overall, we consider the Guideline is quite pragmatic and workable.

However we have identified six areas where it might be improved.

Our perspective is the impact on consumers, where poor elements of the RRO design may lead to:

- onerous costs of compliance, ultimately passed through in prices; and / or
- higher wholesale energy costs for retailers, driven by excessive levels of contracting driven not by prudent risk-management, but by RRO compliance obligations in excess of the minimum necessary to assure the Reliability Standard is met under expected conditions.

The second of these is far more serious in our view.

Our recommendations (explained within) are summarised as follows:

1. Allow bespoke, audited approaches to consider the combination of ex-ante hedge policy and ex-post compliance with policy in assessing firmness – using swaptions as an example.
2. Ensure it is clear that hedge contracts are valid for compliance regardless of whether the underlying asset (or upgrade to an asset) is captured under AEMO's definition of "Committed".
3. Eliminate opportunities for gaming the volume of contracts, by ensuring both buyer and seller report the same compliance volume – using load-following swaps as an example.
4. Clarify the difference between a "contract" and a "sale" to reduce risks of "wash trades" leading to double-counting of contract volumes.
5. Resist pressure to heavily discount the firmness of reliability products with higher-priced strikes.
6. Treat the expected capacity of variable renewables over the gap trading intervals accurately and consistently.

Yours sincerely,

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1. Firmness of Swaptions – allowing hedge policy to be considered

We use the particular example of a retailer buying swaptions maturing after T-1.[1]

Under the Guideline, the firmness would be based on the delta of the swaption at T-1. This is always going to be less than 1 due to a combination of remaining time to expiry, and the extent to which swaps for the relevant period are above or below the swaption strike at T-1.

It may be materially less than 1, if the swap level at T-1 is substantially lower than the strike – which we note, indicates there probably is no reliability gap to worry about. It is very unhelpful to have an RRO firmness structure which drives more and more contracting, the less and less likely the gap is to exist.

Note that it is always rational to hold a swaption to expiry, after T-1 in this example. If the retailer does in fact require hedge cover, it will then:

- either exercise it (and buy the swap, firmness equal to 1)
- OR let it lapse… and buy the swap on-market at the cheaper level, firmness also equal to 1.

The only outcome which has NOT led to completely firm contracting is if the retailer allows the swaption to expire but does not buy a swap at the cheaper price – which is a situation we believe can be handled via common-sense auditing of policy and practice, outlined below.

Forcing such a retailer to acquire other contracts for compliance purposes, when the swaption itself is potentially a perfectly suitable hedge, is likely to lead to excessive contracting, and potentially contracting at levels higher than necessary – with the impact of driving up contract prices and thus consumer prices (all else equal).

An alternative is to take a broader view, under an auditor-approved bespoke methodology.

In this example an auditor might consider two things:

1. The prior existence of an explicit hedge policy which makes clear that firm cover must be obtained at or very shortly after expiry of swaptions – i.e. the policy is to either exercise the swaption, or buy the swap cheaper.
2. The subsequent assessment of policy compliance after the gap has begun or passed – and any non-compliance can lead to non-approval of the firmness factor when the question of cost allocation for reliability failures is assessed.

This highlights an important point: the firmness of the contracts ARRANGED and REPORTED at T-1 can be ASSESSED ex-post, because they only need to be assessed at all after the event, and only when a reliability failure has required allocations of costs.

In practice, non-compliance in this case would lead to adjustment of the T-1 contract position prior to any cost allocation.

This approach would also, in our view, be simpler than alternatives such as rolling forward time in assessing delta, or relying on thinly-traded ASX volatility curves which might be subject to manipulation.

2. Validity of contracts, regardless of the seller

The Guideline refers in a couple of places to AEMO's definition of "Committed", in relation to planned capacity upgrades of existing assets, for PPAs and internal hedges.

What about internal hedges with new-build capacity, not yet "AEMO Committed"? The Guideline is silent.

The purpose of the RRO is to encourage additional capacity to meet a gap. Disallowing contracts with certain undeveloped assets would be quixotic as well as inconsistent.

[1] the retailer buys the right to buy a swap covering the gap period at a fixed price, expiring after T-1, but prior to the gap period.

The overall approach to contracting does NOT require explicit links to particular assets, but allows for financial contracts to be considered as representing strong incentives for encouraging firm capacity to support the risks.

Given this, we think there should be no reference to AEMO's strict definition of "Committed" in the cases noted, especially as this could be taken to apply more generally.

In fact, be believe AER should be explicit that the principles hold: any contract with any entity (not asset) which creates the risk exposure should be valid, in exactly the manner in which an ASX swap may be sold by anyone, with no consideration of what stage of development their underlying assets may be at the time (if any!)

3. Eliminate space for gaming contract volumes

The Guideline suggests when two liable entities exchange a load-following swap, the volumes for compliance at T-1 will be "100%" for the buyer (i.e. a placeholder at T-1, to be assessed after the event) but a nominated estimate of the buyer's 1-in-2 year peak demand for the seller.

The buyer has no risk (nor should they) but the seller has an incentive for the nominated volume to be low, to ensure it minimises the netting off of their own RRO contracting position. This incentive might play out in negotiations!

This is a clear risk of gaming that would skew outcomes towards over-reporting actual contracted volumes among the two entities, if push comes to shove and costs need to be allocated.

The solution seems relatively simple – the seller should also report a placeholder at T-1, and in the event of any need to assess compliance, buyer and seller must "fill in the blank" with the same actual (scaled to 1-in-2 year peak) volume.

Again, because any meaningful assessment will be ex-post, there is no reason buyer and seller cannot be treated identically

4. Clarify what is a "contract" to reduce risk of wash trades

The risk here is a non-liable entity may buy a contract from a liable retailer which could variously be described as a "swap" or a "fixed price, fixed volume electricity sale & purchase agreement" – since they are equivalent in many respects.

We think the Guideline needs to be clearer on when an arrangement must be netted off against the liable entity's RRO firmness (because it is a derivative-like arrangement) and when it must not (because it is directly associated with a genuine electricity consumer's load).

Unless the rules are very clear, it may not be obvious whether the contract is to be netted off the RRO contract position or not. If the buyer is not a genuine customer (but perhaps has structured things to look a lot like one), they might resell the contract to another liable retailer, thereby double-counting the quantity contracted for the RRO overall.[2]

We suspect the answer here is probably a simple matter of clear definition of the characteristics of a "real" customer sale agreement not requiring netting off, but the Guideline should not be silent on the issue, as it is presently.

5. Resist the urge to disincentivise high-cost but effective reliability assets

We note the proposed use of an arbitrary 5% of MPC threshold for the strike of cap contracts, after which the firmness of a cap contract declines towards zero.

We appreciate the risk of liable entities complying with the RRO very, very cheaply, by acquiring very high-strike caps or similar option-style products. We agree that at the extreme, the sellers of such products face little risk (due to the MPC) and would be unlikely to spur investment in capacity.

[2] e.g. Retailer 1 sells a fixed-price arrangement swap to a "customer" who then on-sells it to Retailer 2. Retailer 2 can claim it against the RRO as a firm contract, but Retailer 1 arguably doesn't have to net it off.

However we also appreciate the arguments against penalising higher-strike contracts (thus likely, higher-cost underlying assets).

The RRO is not designed to compel contracting with low-cost capacity. It is designed to avoid the need for the RERT to be used, at costs in excess of the MPC.

The best portfolio of capacity to meet the reliability standard will likely have a spread of costs, with some assets (perhaps demand response or small pumped hydro, or hydrogen turbines, or …), at relatively high costs but very infrequent utilisation… perhaps only during the worst periods of any reliability gap.

Such assets / contracts are only recently emerging – and should not be disincentivised by the RRO design.

Therefore, we suspect the "5% of MPC" or $725/MWh is too low, not too high as some suggested. Genuine capacity at (for example) 20% of MPC or $2,900/MWh that can dispatch for an hour or two is exactly what may be needed to avoid a reliability incident. The market design comfortable allows for periods of price at this type of level – AER does not even need to investigate!

Such contracts would still face very substantial exposure to the MPC if they were not supported by underlying assets, and so the risk of unsupported contracting at this level seems limited.

We would suggest a limit of (say) 20% of the MPC might be a better threshold for caps.

In the case of options (or other non-cap contracts where the explicit firmness formula cannot be used), there should be consistency – the way to achieve this would be to assess the delta of such contracts under conditions of the market price at the same level - $2,900/MWh in this case. The resulting deltas would be higher than if assessed at the market level of prices at T-1 – but still less than 1 due to the remaining time value.

Note the principle here: if prices are at $2,900/MWh (because there really is a reliability gap looming), does the entity have a firm contract to protect them against prices towards the MPC, and is that contract carrying enough risk for the seller that it is likely supported by capacity?

We think the answer is yes and yes.

Above this level (presuming it is set with some physical basis such as evidence of the marginal cost of short-term firm demand response contracts) we would be comfortable with a more aggressive deterioration in firmness factor from that (higher) starting-point towards the MPC.

6. Treat the gap capacity of variable renewables accurately and consistently

In illustrating the reliability of a solar PPA, the Guideline notes the capacity factor for the time of day would follow the expected decline from afternoon into evening.

However, in the case of a wind PPA, the Guideline suggests a come (e.g.) 20% capacity factor across the later afternoon / evening might be used.

We think there should be consistency. Buyers and sellers of such contracts will be well-aware of the expected capacity factor variation by time of day, and this should be used – which might be good or bad for the wind farm in this case.