



# DRAFT INTERIM QUALIFYING CONTRACTS AND FIRMNESS GUIDELINE

Response to AER  
consultation paper

June 2019

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## 1. Executive summary

Thank you for the opportunity to provide feedback to the consultation of the development of Draft Interim Qualifying Contracts and Firmness Guideline (DIQCFG) associated with the Retailer Reliability Obligation (RRO).

Stanwell broadly agrees with the draft interim guideline, but there are some issues that require clarification or modification, including:

- The use of an option’s delta as the default firmness factor;
- The firmness factor approach for qualifying contracts does not account for correlations between three types of risks identified;
- The firmness factor methodology for internally hedged generation risks discriminating against vertically integrated participants;
- Removal of the requirement for auditor approval of the application of the approved bespoke firmness methodologies; and
- Simplification of the summary net contract position reporting requirement and liable entity sign off.

The option for liable entities to use bespoke firmness methodologies for standard qualifying contracts would address a number of the issues raised in this submission.

Given the obligation will be operational in less than one month, Stanwell appreciates that it might not be possible to address all concerns raised in this submission for the interim guideline. Some issues may have to be revisited during the development of the final guideline.

Stanwell welcomes the opportunity to further discuss this submission. Please contact Evan Jones on (07) 3228 4536.

This submission contains the views of Stanwell Corporation Limited in relation to the DIQCFG information provided to date and should not be construed as being indicative of Queensland Government Policy.

## 2. Default firmness methodologies

### **Compulsory default firmness methodologies**

The consultation paper states that “We have provided default firmness methodologies that must be applied when assessing the firmness of standard qualifying contracts”.

Stanwell suggests liable entities should be able to use a bespoke methodology to value standard contracts if they prefer. All bespoke methodologies require Independent Auditor approval, assuring the AER that the decision to use a bespoke methodology instead of the standard methodology is appropriate.

A specific example of where this flexibility may be beneficial is in relation to options, discussed below.

### **Firmness factor approach**

The proposed process for calculating a firmness factor of a qualifying contract is:

$$\text{Firmness Factor Price} \times \text{Firmness Factor Volume} \times \text{Firmness Factor Other}$$

This would be simple to apply, but does not appear to account for correlations between the three types of risk identified.

In order to account for these correlations, a firmness factor approach to modelling that considers the contract as a whole, rather than modelling each risk separately and multiplying the factors together, is required.

Stanwell suggests the interim guidelines allow liable entities to use a bespoke methodology to model the factors together if doing so provides a more accurate reflection of the contract’s firmness during the reliability gap period.

### **Cap firmness methodology**

Stanwell agrees that standard caps (currently \$300/MWh) should have a firmness of 1 and Market Price Cap (MPC) caps (currently \$14,500/MWh) should have a firmness of zero. The exact path between those points may be contentious, but the proposed solution appears reasonable.

Stanwell would not support a methodology that saw firmness drop to zero significantly below MPC as that would contradict the intent of the RRO – to encourage the provision of physical supply options to support reliability. Physical resources which are available at or near MPC still contribute to reliability and are anticipated under the process whereby the Reliability Settings (Market Participant Factor, MPC, Cumulative Price Threshold and Administered Price Cap) are set.

### **Options firmness methodology**

The proposed approach of using an option’s delta as its firmness factor may not capture the actual firmness of the option. This is because standard option models include a significant time-based uncertainty component a year ahead of expiry, meaning that at- or marginally in-the-money options have a delta around 0.55.

For example, a retailer may purchase call options to secure their maximum hedging cost for a new retail campaign. In buying the call options the retailer gains volume certainty and a cap on pricing. Later, they have the option to exercise their call option or purchase a swap (if the market price is lower than the option strike).

Assuming a gap had been declared for part or all of Quarter 1 2021, a retailer has three standardised option products which may assist with hedging and RRO compliance – a Financial Year ending 2021 American call option, a Calendar Year 2021 American call option and a Quarter 1 2021 Asian call option. At the money volatility on 12 June 2019 indicates volatility measures of approximately 16 per cent, 16 per cent and 30 per cent respectively. If those volatilities are applied to the option at the reporting date (assumed to be 31 December 2019), at the money options would have deltas of 0.53, 0.53 and 0.58 respectively. This is despite the buyer (retailer) holding protection from price increases equivalent to a swap (firmness = 1) while retaining beneficial exposure to price decreases occurring before option expiry.

Standardised option products	Volatility	Delta
Financial Year ending 2021 American call option	16%	0.53
Calendar Year 2021 American call option	16%	0.53
Quarter 1 2021 Asian call option	30%	0.58

**Table 1: At the money volatility and deltas as at 12 June 2019**

Under these circumstances, using the proposed delta-based approach to option firmness would penalise a retailer for a normal risk management approach (one which ultimately minimises costs to electricity consumers).

In addition, the decision to exercise an option may not just be about the headline price. A retailer may exercise an out of the money option when availability of the underlying contract is low (e.g. as may be the case in South Australia) or if the option is in the money with respect to the underlying contract plus the potential Procurer of Last Resort penalties.

Stanwell suggests the AER consider amending the default approach so entities can adopt a bespoke methodology in accordance with the AER guideline.

### 3. Bespoke firmness methodologies

#### Firmness factors for internally hedged generation

Stanwell considers that the wording relating to internal hedges creates unnecessary confusion and should be simplified. The terminology in the guideline that a “liable entities must firmness adjust an internal hedge...” implies that an adjustment would need to be made to the notional internal transfer rather than the source generation.

Stanwell understands the intent is that a liable entity which owns generation is to firmness adjust the generation in its NCP report (as a resource which decreases the liable entity’s adverse exposure to high spot prices). Any internal hedges relating to that generation portfolio would then be net-neutral in terms of the NCP report since both the buy and sell must be included. If generation is not adjusted in this way, it is not clear how only one side of an internally hedge would be recorded when reporting NCP.

For entities where a generation asset is not covered by the NCP it is unclear why this should be treated any differently to an arms length transaction with an independent generator and retailer.

Participants also require clarification about how the AER will interpret the inputs into the calculation of firmness factors for internal hedges. For a unit that has been in cold storage, historical generation would not provide a reasonable indication of the unit’s expected availability during the reliability gap period. Are generators allowed to consider but not include the inputs listed in the DIQCFG and substitute other inputs (in this case, forecast generation) when calculating their firmness factor?

To address these issues, Stanwell suggests that generators be permitted to develop bespoke methodologies for calculating the firmness factor of internally hedged generation.

#### Independent Auditor approval of bespoke firmness methodology

The consultation paper states:

*“If a liable entity’s net contract position includes non-standard qualifying contracts, it must be accompanied by a report from an Independent Auditor from the Auditor Panel established by the AER. The report must state whether the Independent Auditor considers the bespoke firmness methodology and firmness factor used in relation to the non-standard qualifying contract has been developed **and applied** in accordance with the firmness principles and the firmness methodology set out in section 4 of this guideline” (emphasis added).*

It was Stanwell’s understanding during the development of the RRO that an Independent Auditor would approve a liable entity’s approach, which the liable entity could then apply in future years (without the need to be reaudited) when preparing their net contract position (i.e. the auditor would not check the **application** of the bespoke methodology).

Requiring Independent Auditor approval of each liable entity’s application of pre-agreed methodologies will prove a sizeable burden on industry in the two months between T-1 and contract reporting day. It also appears unnecessary given liable entities have every motivation to ensure the audited methodology is correctly

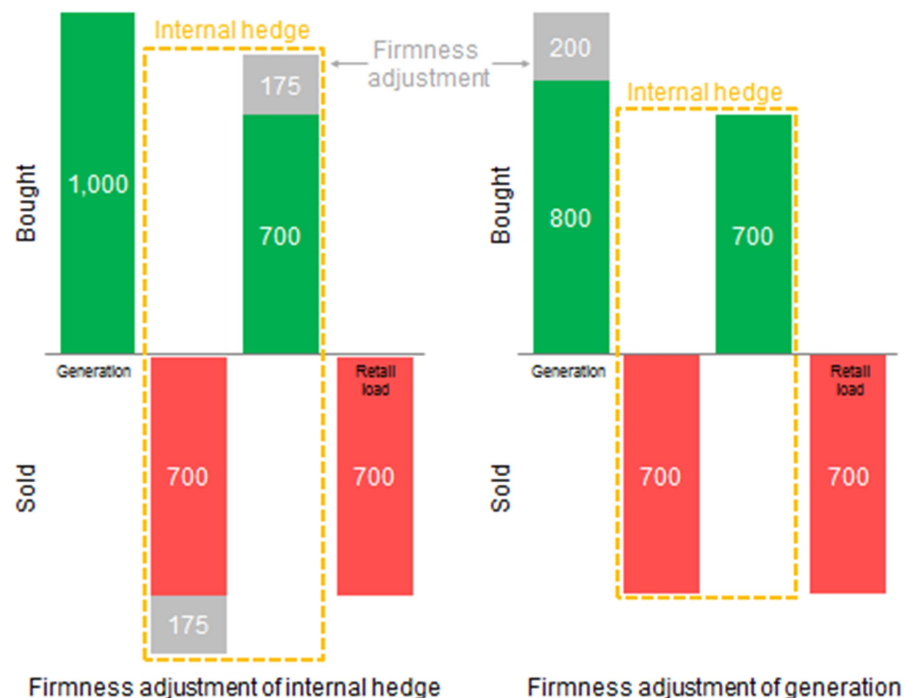


Figure 1: Firmness adjustment of generation or internal hedge

applied. The seriousness of the obligation is reinforced by having the net contract position report signed by a Company Director<sup>1</sup>.

Further, the process of adjusting net contract positions after position day does not require a reaudit of calculations.

Given these apparent inconsistencies within the DIQCFG and the compliance burden of the current rule, Stanwell requests the removal of the words “and applied” from the consultation paper (page 31) and the removal of “and firmness factor” from 4A.E.5(b) in any future revision of the Rules.

#### 4. Net Contract Position reporting

##### *Net Contract Position report*

Given the compliance load on liable entities in the two months following T-1, the requirement that the net contract position (NCP) report be “certified by a director of the liable entity in accordance with the Contracts and Firmness Guideline” may not be pragmatic, particularly given not all Chief Executive Officers are directors. In order to reduce the compliance burden, Stanwell suggests 4A.E.6(c)(1) be expanded to include “or delegate” in any future revision of the rules.

##### *Summary of net contract position*

Example 1 states “the liable entity must also submit the expected maximum demand for the gap trading intervals **based on its** net contract position for those intervals” (emphasis added). Expected maximum demand is not based on net contract position; the net contract position is based on the expected maximum demand. Stanwell suggests the wording in this section be clarified.

Example 1 continues with “the expected maximum demand is the liable entity’s likely share of the system one-in-two year peak demand at the time of the reliability gap.” The reference to one-in-two year peak demand is related to compliance and not related to how a retailer would actually hedge. Forecasting a retailers’ share of actual maximum demand is a sizeable undertaking (greater than forecasting customer peak demand or customer demand at peak demand), and not something that is routinely calculated. To avoid confusion, Stanwell suggest the reported maximum demand is simply the retailer’s forecast of maximum demand (which is the demand they would usually be hedging to).

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<sup>1</sup> Or as Stanwell suggests below, a Company Director or delegate.

Stanwell also suggests the AER should consider at least for the final guideline (if timeframes are too tight for the draft interim guideline) a simplified and less burdensome approach to reporting contract positions, especially as compliance may not actually be enforced (as demand may not exceed one-in-two year peak demand).

One option would be for retailers to provide a report of their net, firmness adjusted contract position by half hour. If compliance is required, or if the AER wishes to ask for further information, the rest of the proposed reports could be generated.

##### *Data file formats*

With respect to Table 8.3 of Example 2:

- Does “Quarterly base swap (bought)” refer only to bought swaps, or is this meant to be the net of bought and sold quarterly base swaps?
- Should “\$300/MWh quarterly swap (sold)” be changed to “\$300/MWh quarterly cap (sold)”?

##### *Opt-in Customers*

Stanwell requests clarification of how AEMO and the AER will separate opt-in customers from a retailer’s compliance figure and NCP. Rules clause 4A.F.3(b)(1) indicates that load for prescribed opt-in customers will be removed from a retailers liable load by AEMO, but does not indicate the same process for large opt-in customers. It may be beneficial to include the opt-in customers as a 100% load following contract in the retailer’s NCP, with the customer as the counterparty.

##### *Global Settlement and unaccounted for energy*

Stanwell requests the guideline makes clear that unaccounted for energy (UFE) assigned to a retailer will not be considered in determining compliance with the RRO. UFE is an unknown volume arising from the recent Global Settlement rule change, and is outside the influence or control of most (or all) retailers. While the value of UFE would be expected to decline as meter sophistication improves, it may be material in the early years of operation (commencing Financial Year 2022).

##### *Adjustments to net contract position*

With respect to adjusting a net contract position in response to an increase in load, the consultation paper states “For the purposes of determining whether the adjustment threshold has been satisfied and a net contract adjustment is permissible, **a liable entity’s net contract position at T-1 is used to determine the liable entity’s forecast demand**” (emphasis added).

Comparing forecast load to T-1 contract position may underestimate the amount a retailer's load has changed as the retailer may have over hedged at T-1. As retailers are already required to report their forecast load at T-1<sup>2</sup>, Stanwell suggests this is compared to the load which is forecast at a later point in time.

## 5. Consultation questions

### Question Three

*The AER is aware of contracts between liable entities and their customers (energy supply agreements) that pass through spot price volatility risk to the customer. These contracts have not been addressed in the draft version of the interim guideline. The AER is interested in stakeholder's views on how these contracts fit into the qualifying contract framework.*

Stanwell's understanding from the design process was that retail supply arrangements were intended to be excluded from the qualifying contract arrangement except where grandfathered under clause 11.116.8<sup>3</sup>. The guidelines should reflect this approach.

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<sup>2</sup> Noting Stanwell's suggestion that the forecast load reported be the retailer's actual forecast load rather than their share of the one in two year peak demand forecast.

<sup>3</sup> The consultation paper references Rules 11.115.8, which was the relevant clause in the draft RRO Rules.

