

17 November 2022

Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Reference: ERC0290

### **Operational security mechanism Draft rule determination**

Snowy Hydro Limited welcomes the opportunity to comment on matters raised in the Draft rule determination from the Australian Energy Market Commission (the Commission) on the Operational security mechanism.

Reforms to values system services are welcome by Snowy Hydro. The growth of variable renewable energy and the retirement of thermal capacity has increased the need for essential system services. The need for such services is now physical reality and the market must provide sufficient incentives to ensure they are adequately supplied.

The Operational security mechanism (OSM) is attempting to define, value, procure and schedule security services in the NEM but the design proposed by the Commission does not form part of the critical path to creating markets for system services. The intent of valuing system services from markets is to drive investment not the need for a scheduling mechanism designed to address AEMO's lack of confidence in the current dispatch process.

If the OSM remains in place and market mechanisms are not adopted then the right investment will not be in place in the future for the NEM. There is a misled belief that markets can be formed just in time to achieve the investment required. This is not the case and AEMO and the NEM do not want to rely until existing assets achieve short term fixes and provide short term certainty of supplies.

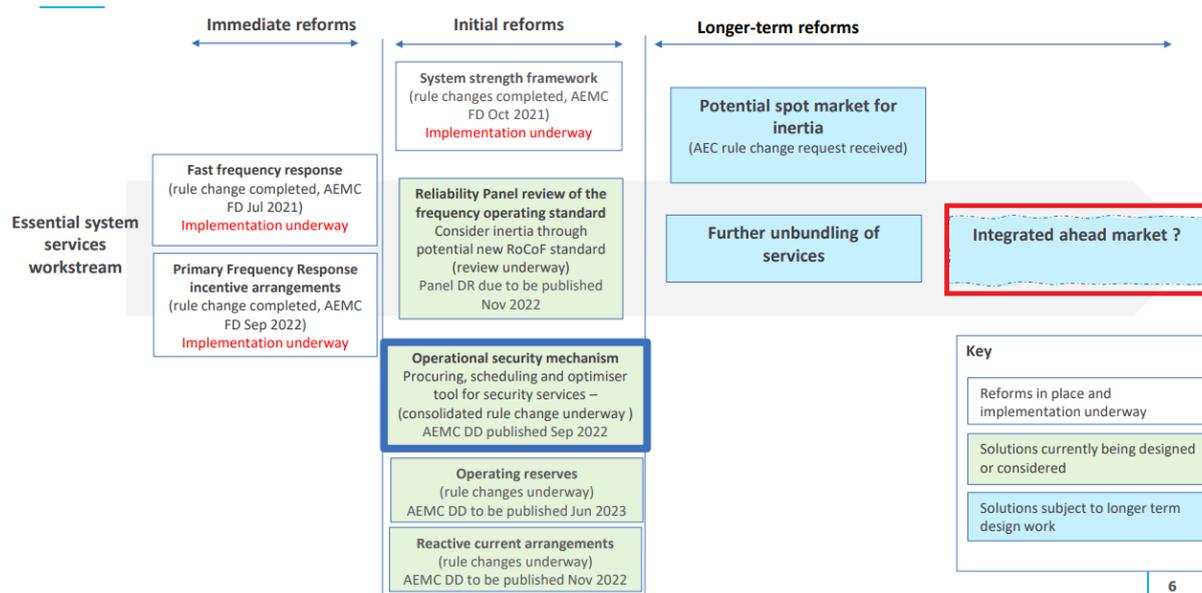
The Commission should instead be recognising that the system strength incentive framework will address the historical constraints and that the Australian Energy Council (AEC) inertia rule change request should be progressed as soon as possible to minimise the need for the OSM to be used for non-unbundled service.

The OSM proposal, should it proceed however, should serve the purpose of unbundling the Essential System Services (ESS) by defining and unbundling these services so as they can be individually priced. The Commission's intent for a long-term goal to value services through markets is welcome, however there is a significant risk that having OSM in place will lead to less interest in developing unbundled ESS markets.

### **OSM is turning into an Ahead Market**

The OSM proposal, which has evolved over the past year, bears many similarities with earlier attempts to introduce an ahead market. ESS does not warrant a day-ahead market or any further aheadness. The ESB under the Post 2025 Market Design consultation correctly noted that interventions highlight the need for structured procurement of ESS. It is therefore important to focus on the lack of a market or other structured procurement mechanisms for some ESS, and not be side tracked by ahead mechanisms. The need for structured procurement of ESS does not imply a need for OSM; and to a longer term ahead market. The recent forum undertaken by the Commission highlighted the risk of an ahead market, highlighted in red below.

## Our essential system services work program progresses ESB recommendations



While defining services is critical to unbundling these services, introducing additional 'aheadness' into the dispatch process has not been justified. There continues to have been little consideration for how a OSM would impact and potentially disrupt the contracts market, which underpins long-term investment in the NEM;

As was the case with the Unit Commitment for Security (UCS) proposal, OSM wrongly assumes that dispatch outcomes can be maximised by the market operator interrogating participants' operational and resource costs, rather than having those costs revealed through a competitive bidding process. Any increase in confidence in the current scheduling/dispatch process enjoyed by AEMO would come at the expense of a loss of efficiency and greater risk for market participants. In particular, introducing bidding gates would restrict generators' ability to efficiently respond to developments in the market.

The Commission should continue to prioritise arrangements such that system services are provided within energy and FCAS markets, without the need for any other mechanism. Accordingly OSM should be assessed independently to avoid the hazard of becoming a permanent feature. OSM risks further delaying the introduction of missing markets for system services and undermining system security.

### Objective to drive investment

The Commission's key objective is to "establish arrangements to optimise the reliable, secure and safe provision of energy in the NEM, such that it is provided at efficient cost to consumers over the long-term, where 'efficient cost' implies the arrangements must promote"<sup>1</sup> This can only be achieved by driving investment in the long-term and not through an OSM mechanism.

The Draft Rule Determination notes that "OSM's objective function would seek to maximise the value of trade to coordinate the dispatch of security services alongside the existing markets of energy and FCAS"<sup>2</sup> This does not demonstrate how it is expected to drive investment when participants under the OSM will be required to bid their fixed and variable costs without understanding scarcity pricing, a key element in driving investment.

<sup>1</sup> AEMC, Operational security mechanism, Draft rule determination, 21 September 2022, pp10

<sup>2</sup> AEMC, Operational security mechanism, Draft rule determination, 21 September 2022, pp v

The Commission attempts to retain a fundamentally self-committed energy and FCAS market but through the objective of the OSM will instead lead to central commitment for products that already have a common price market. This leaves no incentive to innovate or reduce costs with little investment to increase competition in the market.

The Commission's expectation to proceed with OSM is then met by the Australian Energy Regulatory (AER) cap to consider market power concerns, with participants being faced with ineffective pricing and competition under OSM.

### **Operations of the OSM**

The operations of the OSM needs to develop clear standards and/or operational metrics on which procurement is based and should be subject to the Reliability Panel oversight.

The Commission notes that *"gate closure is important for certainty that security would be achieved"* while noting the significant concerns raised by industry with AEMO having the ability to make decisions on behalf of participants ahead of dispatch. The Commission instead considers that gate closure in advance of dispatch is required for the OSM and AEMO would need time to run the OSM engine before dispatch and would need certainty at this time about the volume and prices for security services available.

It is concerning that the Commission is preferencing certainty for AEMO and ignoring the unintended consequences associated with the gate closures as well as the overwhelming opposition to this proposal from industry. Gate closures for example make it hard to incorporate changes in forecast and actual renewables output leading to inefficient market dispatch. The inefficient market dispatch can be further worsened if energy and FCAS prices unexpectedly spike up and the design recovers back values. The consequence of this leads to generators being unable to cover contracts leading to a barrier to entry. The Reliability Panel has the expertise to oversee this process and would strongly recommend this to be looked at.

### **Obligations of the OSM**

To help ensure the OSM provides a pathway to a sustainable market and new investment there will need to be obligations in the rules for AEMO. AEMO should have an obligation in the rules to identify how new entrant resources could participate in the relevant OSM constraints or combinations.

In addition to this, AEMO should be required to provide scenario planning through a transparent framework using existing reports or undertaking new reports. It is critical that AEMO has a clear and published plan for transitioning from any constraints that rely on existing units even before any closures are announced, to allow for the possibility of technical failures or outages.

This scenario planning would provide a forward looking signal and allow participants to understand how OSM will exit in the future and how markets will evolve. Investors need signals and the services need to be unbundled. Market power will not be an issue in most cases if the need for new resources is signaled to the market ahead of time.

The Rules should therefore include an obligation for AEMO and TNSPs to publish what new entrant resources or capabilities could participate in the OSM constraints/combinations.

### **Participation and Market Power**

The objective of the Commission is to introduce a form of competitive purchasing for services where there presently is none. The NEM has successfully operated with very limited market power controls which demonstrates that the first priority should instead be placed on the Commission to develop an effective market before there is any consideration of market power concerns. This however won't be achieved by OSM being in operation longer than required.



The OSM is designed to be initially about combinations of certain generators and as noted in the previous section could be establishing any market power issue through this work. The OSM is likely to be more prone to ineffective competition because markets for system strength are local and have few participants.

While market power is an important consideration in market design, intervention in the form of price caps or other measures carry the risk of unintended consequences and should only be implemented where evidence of actual market power exists. Imposition of such measures could, if applied with greater than necessary zeal, ultimately deter investment and result in an under-provision of services.

Snowy Hydro is concerned that, under the draft determination, market power measures could be imposed based on 'potential market power' where none in practice exists or where market power is conflated with high prices associated with shortfalls in supply. In such circumstances, seeking to cap scarcity pricing will blunt signals for new entry and increase prices for consumers in the long run. Furthermore, the mere prospect that such measures could be introduced under a 'flexible' framework creates uncertainty for investors, who may be unwilling to invest or otherwise face an increased cost of capital given the impact that such measures may have on projected revenues. Furthermore, Snowy Hydro considers that market power measures should be subject to the scrutiny of or should be determined by the Reliability Panel, consistent with the setting of market price settings in the NEM.

### **Transparency and Review of OSM**

Snowy Hydro supports requirements for AEMO to prepare and consult on Security Services Guidelines. To achieve this, we support clear obligations in the Rules that outline the granularity of information that is required from AEMO. Transparency is not just the process and guidelines to demonstrate that AEMO is seeking to unbundle services and not attempting to keep OSM as a long-term mechanism. The market would benefit from clear target dates for AEMO to provide transparency of future needs.

It is for this reason Snowy Hydro does not support a four-year review to update on the OSM developments from the mechanism. Instead the appropriate length for the annual review should be annual and pushed out to 2 years should more time be required. The Commission should focus on the entry of new investments under the OSM proposal to understand whether it is delivering the intended benefits and whether it is contributing to unbundling system services.

### **Implementation**

It is sensible, should the OSM proceed, to implement the mechanism from the 1st of October 2025 as it would allow participants and AEMO time to test and develop the OSM mechanism. The 2025 timeframe however leaves little time for AEMO to then implement a market should more thermal generators come offline which further supports the need for annual review of the mechanism.

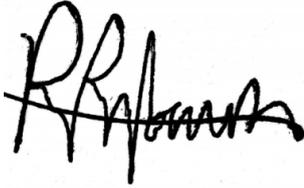
### **About Snowy Hydro**

Snowy Hydro Limited is a producer, supplier, trader and retailer of energy in the National Electricity Market ('NEM') and a leading provider of risk management financial hedge contracts. We are an integrated energy company with more than 5,500 megawatts (MW) of generating capacity. We are one of Australia's largest renewable generators, the third largest generator by capacity and the fourth largest retailer in the NEM through our award-winning retail energy companies - Red Energy and Lumo Energy.



Snowy Hydro appreciates the opportunity to respond to the Draft rule determination from the Australian Energy Market Commission (the Commission) on the Operational security mechanism.. Any questions about this submission should be addressed to [panos.priftakis@snowyhydro.com.au](mailto:panos.priftakis@snowyhydro.com.au).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'P. Priftakis', with a horizontal line drawn through the middle of the signature.

Panos Priftakis  
Head of Wholesale Regulation  
Snowy Hydro

