4 May 2023

Alex Caroly
Australian Energy Market Commission
GPO Box 2603
Sydney NSW 2000

Dear Mr Caroly

RE: Review of the Retailer Reliability Obligation

Shell Energy Australia Pty Ltd (Shell Energy) welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC) consultation paper on the review of the Retailer Reliability Obligation (RRO).

About Shell Energy in Australia

Shell Energy is Shell's renewables and energy solutions business in Australia, helping its customers to decarbonise and reduce their environmental footprint.

Shell Energy delivers business energy solutions and innovation across a portfolio of electricity, gas, environmental products and energy productivity for commercial and industrial customers, while our residential energy retailing business Powershop, acquired in 2022, serves more than 185,000 households and small business customers in Australia.

As the second largest electricity provider to commercial and industrial businesses in Australia[1], Shell Energy offers integrated solutions and market-leading[2] customer satisfaction, built on industry expertise and personalised relationships. The company's generation assets include 662 megawatts of gas-fired peaking power stations in Western Australia and Queensland, supporting the transition to renewables, and the 120 megawatt Gangarri solar energy development in Queensland.

Shell Energy Australia Pty Ltd and its subsidiaries trade as Shell Energy, while Powershop Australia Pty Ltd trades as Powershop. Further information about Shell Energy and our operations can be found on our website here.

General comments

Shell Energy has actively engaged in various consultations on the design of the RRO and changes that have occurred since it was first introduced. We are pleased to have the opportunity to comment on the RRO through the AEMC's review process.

We acknowledge that the scope for this review of the RRO are set in the National Electricity Rules (NER) and informed by the 2018 Decision Regulation Impact Statement (RIS). That RIS explains that a longer-term assessment would be needed to assess the overall impact of the scheme. As such, the AEMC has excluded

[1]By load, based on Shell Energy analysis of publicly available data.

[2] Utility Market Intelligence (UMI) survey of large commercial and industrial electricity customers of major electricity retailers, including ERM Power (now known as Shell Energy) by independent research company NTF Group in 2011-2021.

efficiency from the terms of reference of this review. Paradoxically, the assessment criteria for this review includes efficiency as one of the aspects the AEMC will use to assess their recommendations.

While a longer timeframe may be needed to examine the entire policy, there are elements of the RRO that should be examined through the lens of efficiency in this review. For instance, Shell Energy asserts that it is reasonable to consider whether the RRO encourages efficient behaviour in the retail electricity market and contracts markets. In several cases, Shell Energy would argue that the RRO contains design aspects that are inefficient and require reform. We will go into greater detail about these particular elements throughout this submission.

Process for T-3 and T-1 triggers

The Review asks about whether changes are needed to the T-3 and T-1 trigger arrangements. It is difficult to comment on the need for changes to the T-3 arrangements given that there is already work in train to allow state energy ministers the option to call T-3 triggers irrespective of the reliability assessment modelling outcome in the Australian Energy Market Operator's (AEMO) Electricity Statement of Opportunities (ESOO) modelling. We consider that this is likely to mean that T-3 triggers are called virtually every year in most states as has been the case in South Australia where the SA Minister has had the power to call a T-3 trigger since the beginning of the RRO.

The original intent of the T-3 trigger was to provide an early signal to the market that more generation capacity would be needed in a region. Investors' view of market prices would also guide the decision whether to develop new capacity. What the Ministerial T-3 trigger does is delink the market operator's expectations of reliability from the signal to invest. Ministers may want additional capacity to enter the market by declaring a T-3 reliability instrument, but if the forward price curve does not suggest there is a need for new capacity, then investors are unlikely to develop new generation or storage projects.

A T-1 reliability gap period can still be declared on the basis of a sudden and unexpected change in generation capacity (e.g. sudden unplanned plant outages), or forecasts of improbably high demand. In these cases, retailers must contract for their expected demand more than a year in advance potentially without sufficient new capacity having been brought into the market. To some extent, this is what has occurred in South Australia for the Q1 2024 gap period, where a ministerial T-3 trigger coupled with what Shell Energy considered were restrictive input assumptions in the 2022 ESOO reliability assessment modelling, has resulted in a T-1 reliability instrument being declared.

Shell Energy believes changes to the T-1 instrument process are needed to remove inefficiencies. Our main concern is the impact on retail markets once the contract position day has passed. While retailers must have contracts in place 12 months in advance, customers can contract as they please. This places retailers in a difficult situation. Retailers must estimate and contract for their expected demand a year in advance. If their demand estimates are too high, they will have to wear these extra costs, or may be able to bring on new customers up to their estimated RRO liability. If their demand estimates are too low, they may be unable to bring on new customers reducing competition in the retail markets.

While the National Electricity Rules (NER) contain provisions that allow retailers to apply to the AER to adjust their net contract position due to bringing on new customers under some defined circumstances, there is a catch-22: retailers won't want to sign up new customers unless they can be assured the AER will allow them to adjust their net contract position, but retailers cannot be assured the AER will permit them to adjust their NCP unless they have already signed up the new customer. This creates an inefficient retail market where competition may be diminished as some retailers may be unwilling to take on new customers due to the risk associated with breaching the RRO's contracting requirements.

Shell Energy considers that this inefficiency has been highlighted in the recent T-1 instrument declaration for Q1 2024 in South Australia. The 2022 Electricity Statement of Opportunities (ESOO) showed a reliability gap in South Australia for January-February 2024 and as required, AEMO made a T-1 request to the AER.

Several stakeholders, including Shell Energy, objected to the T-1 instrument on the grounds that AEMO had erred in its classification of various generation facilities as 'Anticipated' rather than 'Committed'. This classification meant that the generation would not be included in modelling for 2024. Examples of these facilities included the Bolivar Power Station, the Tailem Bend Battery and the Torrens Island Battery. The AER sought an explanation from AEMO, who maintained that the projects should remain as 'Anticipated' based on AEMO's classification criteria. However, the rules provide little opportunity for the AER to openly question AEMO in such areas and the discussion is opaque from a market participant perspective. We recommend that the transparency of this AER review process be improved by inclusion in the rules of a mandatory public forum to allow for questions from stakeholders to both the AER and AEMO.

However, AEMO's February 2023 Update to the ESOO showed that the reliability gap in SA for Q1 2024 had disappeared, with little unserved energy forecast. The update included the Bolivar Power Station and Tailem Bend Battery being classified as 'Committed'. The 250 MW Torrens Island Battery remains classified as "Anticipated" despite an announced expected commissioning date of June 2023 and registration into AEMO's market systems on 8 February 2023.[3] Despite the February 2023 update, retailers in South Australia must still have contract in place to meet their expected share of 50POE demand during the originally forecast gap period.

Shell Energy observed significant changes in the South Australian contracts markets around the time of the contract position day, by which date retailers must have their contracts in place. We provided detail of these observations in our submission to the AEMC on the Review of the Interim Reliability Measure (IRM). These additional costs for the gap period are now locked in for consumers.

In our view, changes are needed so that a similar update in the future could allow the AER to revoke a T-1 instrument. Additionally, Shell Energy considers that the AER should be able to request AEMO to reopen the modelling with new information. For example, given the feedback stakeholders provided the AER on the T-1 instrument request for SA in Q1 2024, the AER should have the power to request AEMO to undertake a sensitivity analysis including the generators flagged by stakeholders as likely to be in the market by the gap period. This would allow the AER to assess the potential for minor changes to the supply outlook to remove any reliability gap.

Were either of these processes in place for the recently declared gap period in South Australia for Q1 2024, the AER may have either determined not to make the T-1 instrument or could have rescinded the T-1 instrument following the release of the update to the ESOO.

Even now, although retailers have already incurred costs through contracting to higher levels and earlier than they ordinarily would for Q1 2024 in South Australia, revoking the T-1 instrument would allow for retailers to reprofile their contract books, and offer retail contracts without the risk of breaching the RRO. The ability to revoke a T-1 instrument before the event would lower compliance costs and risks, and improve retail competition. Therefore, Shell Energy recommends that the AER be granted the power to rescind a T-1 instrument and to direct AEMO to undertake additional modelling.

We do not consider that the AER should have the ability to declare a T-3 or T-1 instrument after the respective 3-year and 1-year windows already set in the NEL and NER have passed. This is because Ministers will shortly have the power to declare a T-3 instrument regardless of AEMO's modelling, and AEMO has the ability to

[3] AEMO Change Notice 2943

update the ESOO if there are material changes in forecasts. The RRO framework therefore already has several mechanisms to bring in reliability instruments (where no gap exists or when one occurs due to a sudden and unexpected change). There is, however, no mechanism to revoke a T-3 or T-1 reliability instrument if circumstances change as the AER has recently confirmed.[4]

Market Liquidity Obligation

In the consultation paper, the AEMC discusses the market liquidity obligation (MLO) and the effect it will have as the proportion of scheduled generation declines through retirements, and the increase in semi-scheduled generation. Shell Energy has identified similar issues and contends there is a case to change the requirements for MLO generators.

Given the increasing volumes of semi-scheduled generation entering the market, it would be reasonable to start to include this capacity in calculations for which generators may be required to make bids and offers available in the contracts market. Further work would need to be done to best assess how semi-scheduled capacity would factor into calculations of traced capacity and the volumes of bids and offers that must be made.

Similarly, we believe there is a case for seasonal capacity to be relevant in determining which generators must make bids and offers and the volumes of these bids and offers. By way of example, for a gap period declared in Q1 or Q4, summer capacity should be used, whereas for a gap in Q2 or Q3, winter capacity or non-summer should be used. This would allow for obliged generators to make contracts available based on the expected availability of their plant during the gap period, rather than adopting a broad-brush approach.

Furthermore, we understand that several obligated generators are fulfilling the requirements by offering financial year or calendar year products. While these products to offer contract cover for the gap period, they also require the counterparty to take on load for additional quarters. This adds a financial burden, particularly for smaller retailers. In our view, there is a case to be made that obligated parties should make contracts available for the specific quarter (or quarters) of a gap period. This would enhance liquidity for the specific quarters with a gap period, as in the intent of the MLO.

Qualifying contracts

The consultation paper queries whether changes should be made to what is defined and the process for defining the firmness of a qualifying contract. Shell Energy considers that there are several areas where reform is needed on the firmness of qualifying contracts.

In the first instance, Shell Energy recommends a change to the firmness rating of cap contracts. There are increasingly cap contracts with a range of strike prices that can be traded on markets like FEX, rather than the conventional strike price of $300/MWh. With changing fuel costs and evolving markets, we consider that the current methodology of applying a firmness rating of 1 for cap contracts with a strike price up to 5 per cent of the market price cap (MPC) is unnecessarily stringent. We consider that applying a firmness rating of 1 to cap contracts with a strike price of up to 10 per cent of the market price cap would still adequately incentivise contracting to manage price volatility while opening up a wider variety of contract markets and therefore lowering costs to consumers.

In addition, we believe the treatment of option contracts need to be reconsidered for certain kinds of option contracts. At present, options contracts require a delta value to be used to assess the probability of the contract being available at times of high demand. This is a rational approach from the perspective of options contracts with price-based triggers, particularly those which must be exercised well in advance of the gap period as there

[4] AER, South Australia T-1 reliability instrument to remain in place following AEMO's ESOO update, 6 April 2023.

is uncertainty over whether they will be triggered. Yet, price-based triggers are not the only ones used. Other triggers such as temperature or demand-based triggers, or on the day short-notice exercise options can be used which may be certain to apply during days where RRO compliance may be assessed (i.e., where demand exceeds the 50POE maximum demand value). Continuing to treat these kinds of options contracts as having a firmness of less than one unfairly penalises some liable entities and therefore leads to higher contracting levels, which imposes higher costs on consumers.

In the example of demand-based triggers, where the demand threshold sits below the 50POE maximum demand, we consider the option contract should receive a firmness rating of 1. Under these contracts once demand hits a certain point, the option is automatically exercised. As such, taking the current 50POE maximum demand of 3044 MW in South Australia for Q1 2024, if a retailer held an option for Q1 2024 which triggered when demand hit 2800 MW, then the retailer has managed the risk for times when demand exceeded the 50POE maximum demand value. Similarly, on-the-day or short-notice exercise options are more certain to be exercised where pre-dispatch forecast indicates an exceedance of the 50POE maximum demand value. Some generators find these options to be a good contract to offer due to the firm nature of the short notice exercise call or because it is more reasonable to expect demand to hold above the trigger threshold for a longer period than price spikes, which may only last for five minutes. Shell Energy believes this change would support the aims of the RRO and help lower the cost of compliance, therefore lowering the cost to consumers.

Other issues

There are interactions between the signals that the RRO should provide for new entry and the barriers to new entry that the notice of closure obligation creates. In practice, the notice of closure obligation should deliver certainty to new investors on when plant will exit and therefore, the need for new plant to enter the market. However, the notice of closure obligation does not require a generator to exit on the date advised in the notice of closure– it could be delayed by the participant– and governments have to this point indicated they would consider extending the life of (predominantly) coal-fired generators if need be.

The creates a quandary and enhances risk for new entrants. They may choose to invest and build in part due to the likelihood of a competitor exiting the market. If that exit does not occur, the economics of the project can be harmed. There may be good reasons for exit to be delayed if there is a clear reliability need for the 'exiting' plant to remain in the market. However, the RRO, and the potentially higher contract prices it can bring in advance of a contract position day may create the opportunity for plant to delay its exit (if physically and economically possible). Given these interactions, Shell Energy considers the interaction of the T-3 trigger process and the notice of closure arrangements need to be examined.

Conclusion

In Shell Energy's view, and based on our experience as a liable entity, the current design of the RRO contains several inefficient elements which should be improved.

Chiefly, we consider that the AER must be given the power to request AEMO to undertake sensitivity analysis based on stakeholder feedback and revoke a T-1 trigger if necessary. The fact that AEMO's Update to the 2022 ESOO showed there was no longer a reliability gap in Q1 2024 in South Australia, yet a T-1 instrument remains in place highlights the need for change. This is leading to an inefficient retail market where some retailers may not want to bring on new customers due to the risk of being exposed to penalties and Procurer of Last Resort costs under the RRO.

We also consider that changes to the firmness of some qualifying contracts are needed. We argue that cap contracts with a strike price of 10 per cent of the market price cap should be given a firmness rating of 1. Further, options contracts with demand-based triggers (or similar) where the trigger is below the 50POE maximum demand value should also be given a firmness rating of 1.

In our view, these reforms, alongside others discussed in this submission would deliver improved outcomes to consumers without undermining the intent of the RRO.

For more detail on this submission, please contact Ben Pryor, Regulatory Affairs Policy Adviser (0437 305 547 or ben.pryor@shellenergy.com.au).

Yours sincerely

[signed]

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