



Ms Anna Collyer
Chair, Australian Energy Market Commission
Level 15, 60 Castlereagh St
Sydney NSW 2000

Lodged to online portal at: www.aemc.gov.au

28 September 2023

Dear Ms Collyer,

Improving security frameworks for the energy transition (ERC0290) – Directions paper

ENGIE Australia & New Zealand (ENGIE) appreciates the opportunity to respond to the Australian Energy Market Commission (“the Commission”) in response to the Improving security frameworks for the energy transition Directions paper (“the Directions paper”).

The ENGIE Group is a global energy operator in the businesses of electricity, natural gas and energy services. In Australia, ENGIE has interests in generation, renewable energy development, and energy services. ENGIE also owns Simply Energy which provides electricity and gas to retail customer accounts across Victoria, South Australia, New South Wales, Queensland, and Western Australia.

The proposed procurement arrangements will not compare like with like

ENGIE is disappointed that the Directions Paper signals a shift by the Commission away from seeking to unbundle essential system services so that the resources providing these services – regardless of whether they do so at the same time as providing energy - can be appropriately and efficiently rewarded. We recognise that the development of real time markets for some of these services remains challenging; however, the reform path set out in the Directions Paper risks effectively foreclosing on the implementation of such markets in the future. It is arguably a key function of the AEMC to ensure markets provide the correct mix of incentives and risks to enable its operation with minimal interventions, the continual failure to value such services is therefore disappointing.

It is also reasonable to suppose that the proposed TNSP-based procurement approach will lock-in TNSP-owned resources as the primary provider of inertia alongside system strength. This will reduce or eliminate the scope for market-based resources to efficiently provide such services. The proposed reforms also set no obligation on AEMO to develop a market in due course, and so it is likely that initiatives such as the proposed inertia market rule (ERC0339) will fall by the wayside. It is unclear how this can be considered a desirable outcome.

While the alignment of inertia procurement with the existing system strength procurement framework has some merit, it also has the drawback of repeating the error made in implementing system strength procurement of handing procurement to the TNSPs. This is a problem because the TNSP's procurement approach is to compare self-investment with a regulated return and some protection against cost overruns¹ against a third-party contracting approach that is likely to be characterised by shorter contract length than asset lives and fixed price terms. So, the third party has to bear two types of risk that the TNSP does not: the risk of contract non-renewal stranding their asset and the risk of cost overruns. This means that the RIT-T will be comparing apples and oranges and there is no reason to suppose that it will result in what is genuinely the most efficient solution as a result.

This problem in turn arises from an ongoing conceptual error, which is the idea that service providers should be rewarded for the services they provide based on the type of provider that they are. So, networks are rewarded with a regulated return and market participants are rewarded with a market or contract return. This is only a problem when they are providing the same type of service. The solution is for the Rules to determine whether a *service* should be a regulated service or not and for that to be applied to any provider that delivers the service. There is no fundamental difficulty in developing a mini regulated asset base (RAB) for a market participant providing a regulated service nor for networks participating in a market or procurement round for an unregulated service (providing they do not have an artificial advantage because they are bidding in with customer-funded assets).

In the case of inertia or system strength, regardless of whether the Commission determines that they should be rewarded with a regulated return or not, all potential service providers should be rewarded on the same basis so that their bids can be fairly compared. For this reason, it would be appropriate for AEMO to carry out the procurement. In both cases the service specification and the required levels are partly or fully determined by AEMO already (in the case of system strength) or under the proposals in the Directions Paper (in the case of inertia). To the extent that TNSPs are best placed to monitor that adequate levels of the service are available in their network, they could be granted some enablement rights. Any conflicts of interest that might arise if they are also the contracted party for the service are no greater than under the proposed arrangements (or the existing ones for system strength) and could be addressed by AER monitoring.

Addressing directions compensation arrangements

ENGIE considers that the main problem with existing directions compensation arrangements is that directions continue to be used so frequently, specifically in South Australia. If directions were only used in extremis, as intended, then the compensation arrangements would be of limited concern, providing there was some mechanism to ensure a directed participant is able to recover their costs. The Commission should be explicit that one outcome of the proposed transitional arrangements is that AEMO contracts with parties

¹ There are two components to this. The TNSP can seek a higher cost than that used in carrying out the regulatory investment test (RIT-T) when it makes it contingent project application to recover the costs – as has been seen with recent transmission investment processes such as Project Energy Connect. It is also subject to the Capital Expenditure Sharing Scheme that allows the TNSP to share a portion of any cost overrun with consumers.

to provide services in circumstances where it is clear that otherwise it would have to rely on frequent directions.

Nonetheless, ENGIE recognises that the current arrangements are only cost reflective by accident and there may be merit in considering more appropriate compensation arrangements. The challenge is that it is not possible to fully reconcile all the relevant criteria for compensation arrangements.

The Directions paper states that the compensation arrangements should not provide “any incentive for generators to withhold supply from the market during periods of high [sic] spot prices to earn more revenue by being directed”². ENGIE is unclear on whether the Commission means low rather than high spot prices.

Nonetheless, we infer that the Commission desires a compensation methodology that does not pay materially above any participants’ costs. We note that we are not aware of any evidence of such real-time withholding behaviour (and believe it troublesome the AEMC relies of such assertions without like evidence), and if the Commission wishes to consider incentives, it should also consider incentives on AEMO to make directions a last resort and to explore all available procurement options for relevant services in the first instance.

In fact, if the Commission is convinced that participants have incentives to sit idle until they are directed in real time (an argument which is logically flawed on many levels), then the Commission should not be concerned with permitting generators to opt out of the directions process in the face of any new compensation regime. From ENGIE’s experiences, some assets are suffering significant and ongoing challenges, and threats to their longevity due to the manner in which they are being directed and the limited compensation.

As expected, the most certain way to only pay a specific participant’s costs is to review ex post what those costs were. However, as the Directions paper notes: “additional claims for compensation can also impose a large administrative burden on directed participants and AEMO”³.

Thus, if the Commission is minded to make changes, it would be preferable to define a simple ex ante methodology that would cover all a participant’s costs. But this is not achieved by the proposed methodology for a number of reasons and is not appropriate long-term for the following reasons:

- The heat rates that AEMO uses for the Integrated System Plan (ISP) are more suited to estimating the costs for ongoing generation by a thermal plant. By contrast, a plant that needs to switch on in order to meet a direction and then to shut down afterwards will use more fuel per MWh delivered. As a rule of thumb this could be up to a third more.
- The use of an average heat rate disadvantages less efficient plant (and provides compensation well in excess of short run marginal cost, or SRMC, for the most efficient plant of a given type). If the Commission plans to rely on ISP input data as the basis of the methodology, it should at least use a generator-specific heat rate. This is particularly the case if as the Directions Paper states, a goal of

² p98

³ p97

the methodology is for participants to inform AEMO if they consider ISP assumptions are inaccurate.

- AEMO's fuel costs in the ISP are a forecast that will typically be around two years out of date by the time of a direction. Contracted gas may have been acquired before or after the time of the ISP and thus be at a different price. In some instances, a participant may need to buy gas on the spot market as a result of a direction.
- The failure to incorporate wear and tear, and the potential for inducing early retirement in assets and the incompatibility between participants' commercial portfolio structures over time and the impacts of directions.
- As the Directions Paper observes, storage units have no fuel cost, but they buy energy to charge. So, the proposed methodology would not result in any ex ante compensation for storage

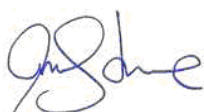
As such, ENGIE considers that the Commission should give further consideration to an opportunity costs approach rather than an SRMC approach. It is important the AEMC not progress proposals which undermine fundamental features of the market and do not continue to incentivise interventions over markets managing risks and participants' pursuing revealed incentives.

An opportunity costs approach would be more likely to make participants indifferent between being dispatched and being directed on than an SRMC approach. It would allow for appropriate compensation for storage. It would allow thermal plant to use spot fuel prices in cases where they might otherwise have sold fuel back into the market (on the premise that they were not expecting to run until they were directed on).

Improved transparency of the directions process would benefit the market

ENGIE supports improvements in the transparency of the directions framework as proposed in the Directions paper. This would be a very low-cost reform. We agree that better information about the reason for the direction in the form of an appropriately specified market notice would provide better real time information to market participants. We also agree that timelines for directions reporting could be improved, and quarterly reporting is a reasonable way to achieve this without imposing undue burdens on AEMO.

Should you have any queries in relation to this submission please do not hesitate to contact me on, telephone, 0477 299 827.



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