4 September 2014

Anne Pearson
Senior Director
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235
Reference: ERC0166

Dear Ms Pearson

RE: OPTIONAL FIRM ACCESS, DESIGN AND TESTING, FIRST INTERIM REPORT

ERM Power welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC) *Optional Firm Access, Design and Testing First Interim Report* (the Report).

ERM Power is a dynamic Australian energy company with interests in electricity sales and generation, and gas production and exploration. Trading as ERM Business Energy and founded in 1980, we have grown to become the fourth largest electricity retailer in the National Electricity Market (NEM) by load, with operations in every state. We have equity interests in 497 megawatts of low emission gas-fired peaking power stations in Western Australia and Queensland, sell conventional gas and condensate from onshore discoveries in Western Australia, and have gas exploration operations in Western Australia and New South Wales.

Our submission consists of two sections. Section 1 explores the case for implementing the Optional Firm Access (OFA) model as proposed in the Report. Section 2 discusses the impact on peaking generators and transitional arrangements to apply if OFA is implemented.

If you would like to discuss the content of this submission further, please contact me on the number below.

Yours sincerely,

[signed]

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Section 1: Assessing the Case for Implementing Optional Firm Access

The AEMC has been tasked by the COAG Energy Council to explore whether implementing OFA in the NEM would be likely to contribute to the National Electricity Objective. Below we outline why ERM Power does not believe a compelling case has been made to support the implementation of the proposed model.

The problem is not well defined

The Report states that the OFA model is intended to strengthen the level of integration between the transmission system and the energy market. However the Report does not clearly define the failure in the current arrangements which the model seeks to address. When describing the proposed assessment framework, the AEMC considers each assessment criterion with respect to the existing arrangements to compare the potential impact of implementing OFA. From these comparisons it is clear that OFA is not a targeted solution to a defined problem, but rather a model that is hoped to incrementally improve a broad range of perceived inefficiencies compared to existing arrangements.

Materiality of these inefficiencies has not been demonstrated by the modelling completed to date. Work by ROAM Consulting found that the existing arrangements were not materially inefficient compared to other proposed models (including OFA). ROAM made the following statement:

> *While there is no clear winner apparent from the modelling undertaken, the outcomes show that the existing package and both proposed packages are capable of delivering market outcomes that are closely aligned with theoretical best practice.* [1]

Nor, we expect, is materiality likely to be demonstrated by further modelling, given the range of complex inter-relating factors and commercial decisions inherent in transmission and generator planning and operations. Any modelling requires numerous subjective assumptions relating to generator behaviour and resultant power flows in the transmission system.

ERM Power believes that declining demand in the NEM means network access in the next decade is likely to improve rather than deteriorate. Further, the Australian Energy Market Operator's (AEMO) recent finding that no new thermal baseload electricity generation will be required over that period means there is no urgency to strengthen locational signals to new entrant generators.[2] The future needs of the NEM beyond this ten-year period are unclear.

Therefore we consider the information presented to date is insufficient to conclude that there is a specific and material problem that should be addressed.

The AEMC's proposed solution is disproportionate to the problem

Good regulatory practise requires that a proposal should be proportional to the problem it seeks to solve. In the case of the OFA model, not only has the problem not been clearly defined, it has not been shown to be material. In aiming to address a range of perceived market inefficiencies, the design proposed by the AEMC represents a significant and highly complex change to fundamental existing operations. Indeed the model consists of five separate but inter-dependent standards and schemes. In our view the OFA proposal is disproportionate to the problem it aims to solve. The result of implementing a disproportionate solution is likely to be net cost to the energy market and ultimately energy consumers.

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[1] ROAM Consulting, *Modelling Transmission Frameworks Review*, February 2013, p. i
[2] AEMO, *2014 Electricity Statement of Opportunities,* August 2014, p. 1

Notwithstanding the significant work undertaken under the Transmission Frameworks Review to consider a number of potential solutions, it remains unclear whether there is a more targeted solution to the inefficiencies outlined in the Report that could represent a more proportional response. If the AEMC is able to clearly prioritise and define specific NEM inefficiencies, it is possible that a proportional solution may be developed to directly address them.

Material net benefit has not been demonstrated

The Report explains that the OFA has the potential to minimise prices for electricity consumers in the longer term by minimising the total system cost of building and operating both generation and transmission over time. Given the significant scale of the OFA solution, a material net benefit must be demonstrated to justify its implementation. ERM Power acknowledges that the model may offer a number of efficiency gains compared to current arrangements. However we are not convinced that these incremental gains are likely to lead to a net benefit.

AEMO also acknowledges the challenge in identifying benefits associated with new but highly integrated market arrangements in its work on access settlements, a core component of the design proposal. When modelling historical market events to understand the impact of the proposal, AEMO states:

> *In each of these events, generator behaviours were also affected by a number of market design and structural issues which are outside of the scope access settlement. It will be difficult to identify the incremental benefits that arise from access settlement alone.*[3]

There remains a great deal of uncertainty around the impact of implementing OFA in the NEM. While theoretical modelling is the most reasonable approximation of the future available, we consider it inevitable that new strategic practises will develop to maximise the commercial outcomes for individual participants under any market framework. These practises cannot be clearly modelled. The risk therefore exists that new commercial practises may be deemed equally or more inefficient than those practises which OFA seeks to address.

Until material net benefit can be clearly demonstrated, ERM Power does not believe implementation of the OFA model can be justified.

Section 2: Impacts for peaking generators

This section discusses the expected impacts on peaking generators if the OFA model was implemented.

The role of peaking generators

Peaking generators are required in the NEM to ensure efficient system supply in a small number of critical events each year (circa 1 - 2% of the year), usually in response to very high demand, or generator or network outages. These events generally occur with less than 24 hours' notice. Peakers in turn rely on dispatch during these very limited periods to remain commercially viable and available to the market. This makes it vital that network access is available at those critical times. It is worth noting that transmission dispatch risk has been negligible for ERM Power's asset since its commissioning in 2000, equating to 15 years of successful operation under the current model to date.

If it was decided that OFA model should be implemented, this would necessarily be on the presumption that current market conditions will not continue and that network access and therefore dispatch risk will become

[3] AEMO, *Optional Firm Access AEMO First Interim Report*, July 2014, p. 3

a material problem in the future. It can be expected that competition for access in general would be strongest during critical peak price events as all generators seek to take advantage of high prices.

OFA provides all generators equal opportunity to procure access where it is of value. Where a particular generator has greatest need for access, it would theoretically be willing to pay a greater price to procure that access than its competitors. However the very short-term nature of most critical peak events means that generators cannot perceive the value of access during those periods until each period arrives, and therefore this cannot inform procurement decisions. This potentially disadvantages peakers compared to baseload generators.

Options available to peaking generators under OFA

There are three choices available for peakers seeking to manage network access where there is risk of congestion. These would apply for new entrant peaking generators, or where insufficient grandfathered access was issued to allow the peaker to retain the existing risk and cost profile.

1. *The peaking generator chooses to not procure firm access*

   A peaking generator may choose not to purchase firm access, saving the cost of procurement. However, where other local generators hold firm access a new financial risk is introduced. If during a critical peak period the peaking generator is dispatched, it will be required to compensate firm generators that are not dispatched. This compensation is an additional cost that will be incurred compared to the existing arrangements.

2. *The generator buys firm access for the entire year*

   To have maximum certainty of either dispatch or compensation if not dispatched, a peaking generator may choose to purchase firm access for the entire year. This would be very costly to the generator and could signal for greater network capacity than what would be required, as the peaker is only likely to use that access for a very small proportion of the year.

3. *The generator buys firm access amounts for periods where there is highest probability of being required*

   The Report does not specify any temporal limitations on firm access products, and it is therefore assumed that the model would allow a generator to purchase firm access for discrete periods in a year. A peaking generator may seek to reduce its access costs by purchasing firm access only during times where it considers there is highest probability of critical peak price events. This would reduce both the risks and benefits of options 1 and 2 above and provide the peaker with greater flexibility in risk mitigation. We therefore believe that if OFA is to be pursued, that the design should provide for the procurement of firm access for discrete time periods (for example, quarters, months, weeks, days, ½ trading intervals).

All three of these options lead to greater costs for a peaker than under existing arrangements. These costs could lead to a higher wholesale electricity price during critical peak periods. We therefore believe there is a strong case for special arrangements to be provided to peaking generators compared to baseload generators.

Transitional access for peaking generators

ERM Power agrees with the AEMC that implied access for existing arrangements warrants grandfathering for existing generators. The Report outlines that grandfathered access would be based on generators' rated capacity. For generators that have been operating for more than two years, rated capacity would be based

on maximum historical output as measured by the revenue meter identifier over a two year period. The AEMC considers this sufficient time for most intermittent or peaking generators to be able demonstrate their full capacity, however ERM Power believes that this does not account for the potentially significant variance in peaking generator output over time. We instead recommend removing the 2 year period restriction to capture the maximum rated capacity over an asset's life to date.

Sculpting

The AEMC proposes the sculpting back of grandfathered access over time to ensure access is available to new entrant generators in the future. It is also recommended that a residual level of grandfathered access should be retained in recognition of the implicit access for existing generators over asset life (Option 3 in the Report). While we agree that sculpting is reasonable for baseload generators, ERM Power believes that special consideration is required in the case of peaking generators. The temporal disadvantage inherent in relying on critical peak events means that peaking generators face greater risks under OFA as discussed above.

One option would be to allocate full capacity grandfathering for peaking generators, with no sculpting of that access over time. This would allow peaking generators to access critical peak events as under existing arrangements. However, we recognise that this would overstate the network capacity required for the majority of the year, and may lead to greater network investment than efficient. We believe the AEMC needs to develop other grandfathering options for peaking generators in recognition for their important role in the NEM, while providing an efficient investment signal.