7 August 2014

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Submitted electronically

Dear Sir/Madam,

Re: National Gas Amendment (Removal of Force Majeure Provisions in the DWGM) Rule 2014

Summary
Lumo Energy's position on the (Removal of the Force Majeure Provisions in the DWGM) Rule 2014 is:

- we do not support the rule change to abolish the FM provisions in the Declared Wholesale Gas Market (DWGM);
- we prefer that efforts are made by the AEMC or (AEMO) to develop a guideline that would help AEMO to apply the FM provisions more effectively;
- were the AEMC to reject this then we would support a full investigation of the market settings together in the DWGM in order to determine that the appropriate market settings are in place before any decision to abolish the FM provisions is made.

Introduction
Lumo Energy welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) Consultation Paper in relation to the National Gas Amendment (Removal of Force Majeure Provisions in the DWGM) Rule 2014 (the Consultation Paper).

Lumo Energy is 100% owned by Infratil Limited, a company listed on the New Zealand and Australian Stock exchanges. We sell gas and electricity in Victoria and New South Wales and electricity in South Australia and Queensland. Lumo Energy is one of the largest second tier retailers.

The AEMC has released a Consultation Paper on a rule change request submitted by the Australian Energy Market Operator (AEMO). The request aims to change the National Gas Rules (NGR) to remove the force majeure (FM) provisions, and to clarify the rules relating to the Administered Pricing Procedures (APP), as they apply to the Victorian Declared Wholesale Gas Market (DWGM).

AEMO argues that the FM provisions in the DWGM are redundant in its rule change request. AEMO determined this position following its review of the DWGM in 2007 where it decided to move from a daily ex-post market to an ex-ante market that was priced in four hourly scheduling periods. In the revised DWGM, market participants would have improved flexibility to manage their portfolios allowing them to reflect changing market conditions into their four hourly scheduling instructions. These changes would effectively mean the FM provisions were no longer required.

In addition to the proposal to abolish the FM provisions in the DWGM, the rule change suggested there was a need to include a "quantifiable trigger" in the DWGM to replace the redundant FM provisions. So, in 2013, AEMO undertook a review of the Cumulative Price Threshold (CPT) where it recommended that the CPT be reduced from $3,700 to $1,800. AEMO effectively decided that a lower CPT would be that "quantifiable trigger" and be an effective way to replace the FM provisions in the DWGM. As a result, AEMO submitted this rule change arguing a reduced CPT level of $1,800 would be an appropriate way to replace the redundant FM provisions in the DWGM.

Key Issues
AEMO's considers that the FM provisions in the DWGM fail to work as originally intended because there is a lack of guidance in the NGR on how they should be applied. In contrast to AEMO's view, Lumo Energy believes the FM provisions are necessary and should be retained. They have the clear purpose of preventing market participants from being exposed to legitimate FM events which could potentially have a serious financial impact on a market participant.

AEMO contends the decision to abolish the FM provisions in the DWGM is necessary because of the difficulties associated with their implementation. In its rule change proposal, it submits that there is a lack of guidance in the NGR on how the FM provisions need to be applied. It suggests that the lack of clear direction in the NGR on how to apply the FM provisions was the catalyst in creating the confusion leading up to the events surrounding TRUenergy's FM application on 08 November 2008.

AEMO's assertion that the application of a lower CPT in the DWGM would be an effective substitute for the FM provisions is challenged in this submission. It is true that a market participant could potentially rely on the CPT as an effective replacement to the FM provisions under most circumstances. However, there are circumstances where this would not be the case.

The substitution of the FM provisions with the CPT results in a serious market design flaw that creates additional risk for market participants. This is especially true in a market where the Market Price Cap (MPC) has been set at $800/GJ. This market design flaw could potentially expose a market participant to an unacceptable level of financial risk resulting in a serious financial impairment.

Lumo Energy highlighted the potentially serious financial impact of an FM event on a market participant relying on the CPT for financial protection in its submission to AEMO's CPT Review in 2013. The requested profile of event cost featured an assumed MPC of $800 dollars for the first scheduling interval for each CPT Event day, with subsequent (intra-day) prices equal to the assumed "normal price". [1]

AEMO modeled the financial impact of this scenario in terms of days of profit foregone as part of its analysis in that review. [2] The scenario depicted in our submission to the CPT Review saw values in terms of profit forgone that were approximately 4 times higher than the alternative scenarios modeled by AEMO. It caused the CPT Event cost to increase quite significantly, which consequently led to an increase in the number of days of gross operating profit foregone.

AEMO dismissed the scenario depicted in our submission on the basis that it was unrealistic.[3] It is interesting to note that in making this decision it failed to provide any accompanying quantitative or qualitative analysis in the CPT Review of 2013 – Final Report to justify its decision.

In dismissing the scenario we depicted in our submission to the CPT Review 2013, AEMO argued that when a retailer is faced with the prospect of an $800 dollar CPT event and a possible multi-day CPT Event that could feature major infrastructure outages and lead to customer curtailment, that some "**portfolio risk management activities would be prudent.**" It then used the NEM as an example arguing VOLL exposure in the NEM requires many retailers to have some load shedding agreements in place.

Unfortunately, AEMO did not clearly explain what it meant that **"some risk management activities would be prudent for a retailer"** in the CPT Review - 2013 when faced with the prospect of an $800 dollar event in the DWGM. We can only assume that AEMO was arguing that the revised 4 hourly gas scheduling periods would provide a market participant with additional flexibility to manage such an event. This would be an effective replacement to the current FM provisions. Lumo Energy questions this logic in two ways:

- AEMO's assertion that a market participant in a FM (stress scenario) would adjust its imbalances in intraday schedules because of the four hourly market fails to reflect the way in which the DWGM works in practice. In reality market participants settle their imbalance positions for balance of the gas day (BOD). If a market participant suffers an FM event before the start of the gas day then they buy the gas that they require for their customer load at the 6am market price $800/GJ. So, they are exposed to this price for the rest of the day.

[1] AEMO DWGM CPT Review Final Report – 16 September 2013 – p. 37.
[2] AEMO DWGM CPT Review Final Report – 16 September 2013 – p. 37
"AEMO has modelled the impact of alternative CPT settings on model retailers when the CPP is set to 35 scheduling intervals (7-days) for the LUMO Energy scenario. The modeling demonstrates the significant financial impact of the scenario that we have presented in our submission and in this paper under scenario 1. "
[3] DWGM CPT REVIEW 2013 –FINAL REPORT – 16 September 2013 – p.62
"The LE scenario was considered when determining the recommendation, but was not thought to be realistic."

- The nature of the more flexible market is irrelevant to managing risk in this situation as a market participant's load has already been purchased and risk management techniques such as load shedding cannot occur at the retail customer level.

More preferable rule change

The AEMC outlines the major concepts that it will use to assess this rule change under the National Gas Objective (NGO) in its Consultation Paper. Of those, the efficient management of uncertainty is the most relevant to assessing this rule change. The question of whether the CPT or the FM provisions represents the most efficient way to manage risk will be important in terms of any decision that the AEMC makes on this rule change.

It is true that in most circumstances the CPT would be effective in managing FM events. The revised four hourly market schedules in the DWGM would allow market participants greater flexibility to manage their portfolios and allow them to reflect the changing market circumstances into their four hourly scheduling instructions.

Unfortunately, relying on the CPT to manage FM risk is fraught with danger in the DWGM. Managing a legitimate FM provision in the NGR could potentially expose a market participant to high price scheduling periods with serious financial consequences. (**See Lumo Energy scenario described above*)

This raises legitimate questions about the CPT and its effectiveness in managing FM events under all scenarios. In some circumstances, the CPT could potentially be viewed as an inefficient way to manage FM events and to manage uncertainty. There is a real possibility that the removal of the FM provisions could potentially lead to the removal of a market participant reducing the level of competition in the DWGM. This would be inconsistent with the NGO.

Lumo Energy's view is the DWGM was not originally designed to operate without the protection of the existing FM provisions. As such, we consider that it would be more logical to work on a policy of improving the FM provisions rather than abolish them completely and potentially expose those market participants to additional risk.

A decision to improve the clarity of the criteria that AEMO applies to implement the FM provisions has merit. The development of clear guidelines that provide greater clarity and certainty to AEMO in the application of the FM provisions in the DWGM would represent a policy initiative in the right direction. An ill thought out decision to abolish the FM provisions could indirectly lead to the potential failure of a market participant.

A sensible alternative course of action

Were the AEMC to reject our proposal to maintain the FM provisions and do more work to improve them, then we consider that it would be prudent to refrain from making this rule change.

Instead, we would advise that the AEMC (or AEMO) undertake a comprehensive review of the appropriate value of all of the market settings in the DWGM together before making this rule change.

A decision to abolish the FM provisions in the DWGM must be made with the full knowledge that the DWGM has the appropriate market settings in place. As such, the AEMC (or AEMO) needs to undertake a comprehensive review of the appropriate market settings in the DWGM together in order to understand how they interact and determine whether they are appropriate.

In June 2009, during the review of the market settings in the STTM, the energy consultants MMA claimed that the methodology of reviewing market settings individually for the STTM was inappropriate. They argued it could lead to distorted results in the analysis with unacceptable decisions and outcomes for the market. In that review, MMA argued that "the combined approach was useful given that each of these three market settings interact with each other such that it is their combined interaction, and not their individual contribution, that determines the outcome risk for retailers and customers". [4]

Finally, we note that the Reliability Panel reviews the reliability standard and reliability settings that apply in the NEM by reviewing the settings together every four years. The methodology applied by the Reliability Panel to determine whether the reliability standard is being met in electricity is to review all of the market settings together. The Reliability Panel considers the MPC, CPT, and MFP and their interaction together before it sets the appropriate market settings to ensure the reliability standard is maintained.

Our view is that it would be prudent for the AEMC (or AEMO) to undertake a combined review of all of the market settings together in the DWGM before making any decision to abolish the FM provisions. It is the combined interaction of the market settings and not their individual contribution that determines the risk in the market for retailers. Given that a critical safety net like the FM provisions is potentially being removed from the DWGM, it is crucial that a combined review of the market settings is undertaken before the FM provsions are removed.

Lumo Energy would welcome the opportunity to discuss our submission with the AEMC. We thank the AEMC for the opportunity to make a submission in response to the Consultation Paper. For any enquiries regarding this submission, please contact Con Noutso, Wholesale Regulatory Manager at Lumo Energy on 03 9976 5701.

Yours sincerely,

Justin Mulder
General Manager Wholesale
Lumo Energy Australia Pty Ltd

[4] GMCC 08- 005-05: MMA Report APC, CPT and CPP.