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Economic Regulation Authority
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Submitted via: www.erawa.com.au/consultation

Draft offer construction guideline

Alinta Energy appreciates the opportunity to provide feedback on the ERA's draft offer construction guideline.

We recommend the following amendments to the current drafting:

1. **We strongly oppose the expectation that compliant offers should conform to a theoretical model estimating a facility's "efficient" costs over time.** [1] A more appropriate question is whether an offer was reasonable, considering the risks and uncertainties present at the time it was made.

   Offers will not conform to a single economic model.

   Many aspects of offers, are not "mechanistic", being based on many uncertain market variables and human perceptions of risks. If a theoretical model could be used to replicate a participant's offers based on efficient costs, it follows that such a model could take the place of traders. Of course, models cannot cater for all the considerations, risks and situations which inform offer prices.

   Even if a participant's offer construction was purely mechanistic, an external model replicating offers could still differ substantially. As exemplified by the annual energy price reviews, different models can differ drastically "efficient" costs due to theoretical rather than actual market changes. For example, AEMO's 2017 draft price limit was revised up 43% largely due to an "issue" that the ERA identified in the "methodology used to calculate the time value of money with respect to start-up costs".[2] This variability indicates how fraught the expectation is that offers should conform to the ERA's theoretical calculations of its costs over time.

   Additionally, we consider that hindsight over whether offers reflected costs during a historical period is not a fair judgement of whether a participant's forecasts were appropriate, noting that this does not account the uncertainties and risks that were present when each offer was made.

   Finally, we note that the blanket expectation that offers should only reflect efficient costs could exacerbate the current revenue inadequacy issues identified by the ERA in its most

[1] We refer to the statement "The ERA expects that over time the weighted average of the generators offers over a particular period should approximate their ex-post efficient cost over that same period."
[2] ERA, *2017 Energy Price Limits Decision*, Sep 2017.

recent WEM effectiveness review and dissuade investment by preventing marginal, flexible capacity (that is increasingly required in the SWIS to balance renewable energy) from recovering any fixed costs not met by the RCM and from gaining any margin on their energy sales.

2. **The requirement for "mechanistic" offer construction methods should be removed.** Per the above, while some components like fuel costs will have readily available calculation methods and inputs, other aspects - including how costs are spread over a run - will not, being more based on human judgement in an uncertain market and under time pressure.

3. **Risk margins should be applicable regardless of whether a participant can "demonstrate why such a loss cannot be rectified by improving its forecasting methods".**

   We consider that this current drafting all but prohibits the use of risk margins in offers. Participants would be uncertain of whether the ERA will judge that the risk could not be covered through its forecasting methods.

   We note that regardless of changes to forecasts, participants will always be exposed to risk. For example, changes in AEMO's forecasts and other participants offers, availability and commitment due to unforeseen circumstances like changes in intermittent renewable resources, constraints and outages can change a participant's run compared to its forecast and render their offer loss-making. We recommend that participants be permitted to incorporate this inherent risk in their offers.

   Rather than require a participant to demonstrate why they were not able to manage risk in their forecast, we consider that a more appropriate consideration is whether the offer was reasonable at the time it was made. We suggest that delineating between what part of an offer is based on a forecast and what is added as a risk margin is unnecessary, potentially confusing, and would create a needless compliance risk.

4. **The guideline should recognise that STEM offers may include additional opportunity costs, flexibility in forecasting and risk margins compared to RTM submissions.** During consultation on the draft amending rules, we advocated that either 2.16A.1 should not apply to the STEM or alternatively, that facilities should no longer be obliged to participate. Our rationale was that it is inefficient to require participants to take a position in the STEM based on imperfect information; and that the main purpose of 2.16A.1 is to ensure least cost dispatch on a given trading day, which is not relevant to the STEM, being a tool to allow customers and participants to hedge. As this recommendation was not implemented, we consider that the offer construction guideline should recognise that the STEM offers may include:

   a. <u>The opportunity cost of selling their capacity in the RTM instead</u>. For example, a facility that would be obliged under 2.16A.1 to offer its capacity at $40 in the RTM should not be required to offer this capacity at $40 in the STEM if $100 prices in the RTM are predicted the next day, all else being equal. If this participant is not permitted to incorporate the $60 opportunity cost of selling in the STEM rather than the RTM, it would be required to transfer wealth to other participants who can arbitrage its position in the STEM. Ultimately, this would present a barrier to entry because it disadvantages participants with generation and storage capacity who are consistently required to make out-of-the-money STEM offers.

   b. <u>Forecasts that incorporate uncertainty in renewable generation</u>. For example, in a hypothetical case where 500MW of wind capacity is expected in a participant's portfolio, we suggest that the participant should not be required to make 500MW of wind capacity available in their portfolio supply curve, noting the large risk that it won't be available in the RTM. Instead, the generator should be able to make much more conservative estimates about how much of their renewable capacity would be operating in the RTM, including for worst-case scenarios.

c. Appropriate risk margins. Risk margins can be described as the returns that speculators expect to receive as compensation for taking another party's natural exposure to fluctuations in prices through buying or selling a commodity futures contract.[3] In the STEM, a risk premium is required as the generators are selling their capacity day-ahead, passing the price risk from the customer to the generator. Prohibiting risk premiums prevents them from being compensated for this price risk. We note that this price risk will tend to be one sided, as the requirement to offer into the STEM and the strict obligations about how to construct offers can suppress STEM prices below forecast prices in the spot market.

5. **Facilities should be permitted to recover their fuel costs.** We disagree with the requirement for generators to price their fuel at what they identify as the market price, where it is below their contract price. This will result in under-recovery, noting that:

   a. Gas-fired generators are required to contract large volumes exceeding their market-based generation needs to meet the 14-hour fuel requirement for Certification of Reserve Capacity. Noting that across all gas-fired electricity generation in the SWIS, such an excess could inundate the small market for very short-term gas trades in WA and would tend to suppress spot prices relative to future prices, the requirement in 4.3.1 would likely require a generator with excess gas to price their supply far below the cost they paid.

   b. Gas-fired generators are also required to contract at least 3 years in advance to receive Capacity Credits. Customers must typically pay a premium to contract over such long terms, especially as the WA market will likely only ever continue to tighten (as forecast by the most recent GSOO). This means gas contract costs will be consistently higher than the replacement cost they are limited to in their offers. We note that the costs of procuring and reserving this capacity 3 years in advance is not recovered through the RCM or any other part of the WEM.

   This requirement will also entrench risk because, as noted by the Brattle paper commissioned by EPWA, WA's domestic gas market is illiquid, small and concentrated, so price discovery is difficult and transacting gas can significantly impact replacement value. This leaves a potentially broad range between ERA and market participants' perceptions of opportunity cost, increasing ex-ante uncertainty.

   Finally, we note that this requirement also benefits larger players with gas businesses compared to smaller facilities and new entrants. These smaller players would not have access to storage or other gas options that would give them a higher opportunity cost when the broader 'market' price is perceived to be lower than their contract price.

   To avoid this, we recommend that participants should be at least permitted to recover their contract price in their offers.

6. **The offer construction guideline should confirm that opportunity costs arising between either providing FCESS or energy may be included in offers.** By reducing generation to be available to provide a raise FCESS, a generator is forgoing energy revenue. Also, by increasing generation to provide a lower service, a generator is forgoing potential returns in the raise market. If a generator cannot incorporate these costs in its offers, it cannot co-optimise them and be indifferent about the service it provides, meaning the generator would likely withhold ESS capacity.

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[3] RBA, *The Term Structure of Commodity Risk Premiums and the Role of Hedging*, March 2016

7. **Facilities should be permitted to offer at the floor for operational reasons.** During an evening ramp, market prices are vulnerable to being lower than forecasts as participants seek to be available for peak times. In these cases, a participant may offer at the floor to avoid being de-committed ahead of the high price period, or having its output changed dramatically and risking damage to equipment. We consider that prohibiting this may undermine availability and reliability and not deliver any benefits. We recommend that the permissions for temporarily bidding below cost be broadened, noting that as drafted, the guideline would only permit this to the extent required to price the start-up costs a participant is seeking to avoid.

8. **All facilities using fuel transport capacity should be permitted to include the capacity costs in their offers.** The current guideline permits small peaking generators to include capacity costs in their offers, considering that otherwise they will not have a prospect of recovering these costs via inframarginal rent or in other parts of the market like the RCM. We consider that permitting some generators to recover additional costs based on assumptions about their inframarginal rent is fraught and would undermine ex-ante certainty. We consider that a more consistent approach would be to recognise that, under the current arrangements, these costs can only be recovered in the energy market and therefore that they should be permitted in all generators' offers.

9. **The following record keeping requirements should be removed:**

   - "Board minutes where matters regarding offer prices into the STEM or real-time market are discussed."

   - "Minutes of any relevant sub-committee of the owner's board that has oversight of the organisation's compliance with clause 2.16A.1."

   As drafted, a participant could breach the first requirement for failing to compile minutes even where their board's discussion of offer prices was circumstantial and not relevant to evidence demonstrating their offer construction.

   Similarly, a participant could breach the second requirement for failing to compile the committee's minutes even where the discussion did not relate to offer construction at all.

   We consider that relevant discussions of both the board and the subcommittee would already be captured by the following requirements:

   - "Records of decisions on risk and strategy regarding recovering efficient costs balanced with compliance with clause 2.16A.1."

   - "Records of changes in strategy or major price revisions, including changes in input costs such at the beginning of a new fuel contract or an engineering review of the technical parameters of registered facilities in the portfolio."

Thank you for your consideration of Alinta Energy's submission. If you would like to discuss further, please contact me at oscar.carlberg@alintaenergy.com.au or on 0409 501 570.

Yours sincerely

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