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Friday, 21 December 2018

Dr Kerry Schott
Chair
Energy Security Board

Dear Dr Schott

RE: Firmness Principles for Qualifying Contracts

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Energy Security Board's (ESB) consultation paper on the firmness principles for qualifying contracts relating to the Retailer Reliability Obligation (RRO).

About ERM Power

ERM Power is an Australian energy company operating electricity sales, generation and energy solutions businesses. The Company has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load¹, with operations in every state and the Australian Capital Territory. A growing range of energy solutions products and services are being delivered, including lighting and energy efficiency software and data analytics, to the Company's existing and new customer base. The Company operates 662 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland.

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General comments

As a first comment, we have assumed that this paper is considering how over-the-counter (OTC) contracts are treated for managing the RRO. ERM Power expects that exchange-traded futures contracts (specifically caps and swaps) will be classified as having a firmness rating of 1 while exchange-traded options will need a separate treatment based on the probability of the option being exercised. A shift from this basic proposition could undermine the ability of non-vertically integrated retailers to manage their RRO compliance and restrict competition in the market.

ERM Power agrees with the four high-level principles the ESB proposes in its consultation paper: the strike price of the contract; the variability and profile of the volume settled under the contract; the likelihood of the contract providing cover to the buyer during the reliability gap; and any other contractual terms which limit the coverage or otherwise reduce the incentive for a seller to "defend" the position.

The ESB proposes requiring liable entities to submit an independent audit report on the entity's contracts and methodology alongside their net contract position to the AER if a T-1 trigger has been declared. This would occur within the T-1 period before any compliance has been confirmed; compliance will only be assessed if demand exceeds the one-in-two-year peak demand forecast. This means that liable entities will incur the costs of an audit irrespective of whether they need to comply with the obligation.

¹ Based on ERM Power analysis of latest published financial information.



ERM Power considers that a more appropriate approach would be for the AER to only require auditor's reports in the event that compliance is to be assessed. That is, that demand exceeds the one-in-two-year peak demand forecast. This would ensure that costs are only imposed when absolutely necessary.

Further, the RRO allows scope for liable entities to adjust their contract positions within the T-1 window to cater to new commercial and industrial customers. The ESB has not indicated how this will fit in with the auditing process. It would be highly inefficient for liable entities to have to re-audit their contract assessment whenever they adjust their net contract position. ERM Power considers that this provides further justification for only requiring audits following the confirmation of the need for compliance rather than in advance.

ERM Power see limited value in the process for pre-approving a liable entity's methodologies and for guidelines that assist in determining the appropriate treatment of different types of financial instruments. It makes sense to have pre-approved values for widely-used and understood contracts like caps and swaps. However, other contracts are already assessed internally by electricity market participants. Under existing accounting standards, firms economically value financial contracts using a delta value. This value is regularly tracked, reported against and audited. Individual firms with identical contract books may have very slightly different delta values due to internal risk allocation metrics but will lie within a very narrow range. Consequently, the pre-approvals and audit process appears to duplicate existing processes with added costs.

Please contact me if you would like to discuss this submission further.

Yours sincerely,

[signed]

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