



Energy Security Board
Email submission to: info@esb.org.au

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Dear Sir/Madam

Re: Detailed Design of the Retailer Reliability Obligation

Rio Tinto welcomes the opportunity to make a submission to the Energy Security Board (“the ESB”) on the three consultation papers on the detailed design of the Energy Security Board’s Retailer Reliability Obligation (‘the RRO’) – *Compliance/Procurer of Last Resort Cost Recovery* (‘the Cost Recovery Paper’), *Firmness Principles for Qualifying Contracts* (‘the Firmness Paper’) and *Material Reliability Gap Definition and Communication* (‘the Gap Definition Paper’). Our responses in this submission are specific only to these three papers. These responses should be considered alongside the feedback on detailed design that we have already given to the ESB Secretariat, including most recently our submission dated 22 November on the *National Electricity (South Australia) (Retailer Reliability Obligation) Amendment Bill 2018*.

As an inherently energy-intensive business, Rio Tinto seeks to produce minerals and metals in the most efficient way possible to both reduce its environmental impact and lower its operating costs. Rio Tinto has interests in three aluminium smelters and two alumina refineries that together use around 10 per cent of the electricity consumed in the National Electricity Market (“NEM”). We support an integrated approach to energy and climate change that delivers a sustainable and durable investment framework.

Rio Tinto sees the role of government, both Federal and State, as creating the right long-term targets and policy to ensure a functioning and effective NEM, one that secures reliable, predictable and internationally competitively-priced energy supplies consistent with Australia’s emissions obligations.

Absent a Retailer Reliability Obligation (RRO) being in place, the outworking of expected reliability gaps such that the reliability standard is not met is either unplanned load shedding or a large cost of procurement by AEMO from the RERT which is then charged to all users in a region independent of their contribution to reliability issues. Both outcomes are problematic for large industrial users with predictable loads such as aluminium smelters and alumina refineries who seek to contract for long terms (5 years plus, and in many cases 20-30 years) in order to manage price risk and ensure reliable supply. Unplanned load shedding fundamentally puts the business at risk as both aluminium smelters and alumina refineries suffer significant consequences if they are without power even for relatively short periods of several hours, and similarly the requirement to pay additional amounts towards RERT, on top of what they have already contracted to pay for the power they use, places an undesirable impost on the business. Accordingly, Rio Tinto supports the implementation of an RRO to the National Electricity Market.

In this submission, we have sought to focus our comments on those matters directly relevant to large industrial customers with long term off-take contracts and have not sought to comment on every element of the design set out in the Cost Recovery Paper, the Firmness Paper and the Gap Definition Paper. Considering each paper in turn:

The Firmness Paper

Of primary interest to Rio Tinto when considering firmness principles is the treatment of existing contracts. The ESB has clearly outlined in previous design documents their intention to allow the grandfathering of pre-existing contracts without firmness testing. This topic area is not covered in the Firmness Paper. As it is unclear whether this will be the subject of a separate consultation, attachment one sets out some areas which the design of the National Electricity Rules ('the Rules') should seek to cater for grandfathering of existing contracts.

When considering the high level principles for firmness adjustment, the treatment of demand management is currently not discussed, whether contracted through a third party or provided by the end user of the contract either directly (for some large industrial loads that are market participants) or indirectly (as a contract provision provided by customers to a retailer). There is some implicit discussion which considers the 'buyer's load profile' but the primary consideration in the Firmness paper appears to be the principles that assess the firmness of the contract coverage provided by a seller rather than the 'firmness' of the required amount of contract coverage required by the buyer. Guidance is required on the principles for the proposed treatment of demand management.

The Firmness paper requests feedback on the level of detail liable entities consider necessary to support the principles. The AER should set out with a deliberate policy to limit the level of detail required from buyers in order to avoid excessive and duplicate auditing and data collection. The Firmness paper implies three levels of auditing: (1) the AER's audit of the liable entity's methodology of assessing firmness; (2) an independent auditor's audit of the liable entity's position in compliance with the AER approved methodology; and (3) an AER audit of additional supporting information from liable entities to confirm that their external auditor's assessment was accurate. There is a risk that the process will be weighed down by the cost and time of excessive auditing. The AER should publish acceptable methodologies for determining the firmness of standard instruments, which should negate the requirement for each liable party to submit its own methodology for those instruments, provided it decided to adopt the AER's methodology. We support an approach where the AER may be approached for guidance on bespoke contracts or positions which do not readily conform to published guidelines, but this should be a voluntary choice rather than a design feature of the firmness testing process. The AER should deliberately seek to create thresholds rather than requiring all the underlying information. For example when considering the strike price of the contract, it should not be necessary for the contract price to be submitted to the AER, only that it was below a threshold or within a range such that it satisfied the pricing requirement of firmness testing. Robust guidelines would limit the need for the AER to review the external auditor's work to unusual circumstances where it appears the guidelines have not been adhered to.

The Gap Definition Paper

As raised in previous submissions, Rio Tinto continues to see a requirement for the circumstances in which the trigger is suspended, bought to a close or alternatively continues over successive years. The design elements put forward to date, including those set out in the Gap Definition Paper, have not dealt with this important issue.

Considering some examples.

- If at time T-1 there is a gap at time T, it must be clear what period the gap extends over. For instance, the long-term forecast may show a gap appearing at the same time each year for the period of the forecast. However, it must be clear that the gap the liability applies to at T-1 cannot extend beyond the period T to

T+1, that is, liable entities should not be required to fix their positions at T-1 for more than one year into the future. In this case, where a gap repeats over several years, there would be a rolling triggering of T-3 and T-1 Obligations through time.

- Similarly if AEMO forecasts a gap and the Obligation is triggered at T-3, prompting either supply side or demand side response such that the forecast gap no longer persists, the trigger should be lifted.. This could occur when the next forecast is routinely published, or earlier.

The Gap Definition paper considers whether the Gap identified at T-1 should be allowed to include Trading Intervals that were not included in the Gap defined at T-3. Although it is recognised that circumstances change between forecasts, the risk of compliance with the RRO could significantly increase if new Trading Intervals were able to be included in the Gap at T-1. Liable entities would be faced with the reality that the Gap identified at T-3 was indicative only and would need to broaden their contracting to minimise the risk of non-compliance at T-1. The size of this risk is magnified by the potential size of the financial consequence of non-compliance. The higher the risk, the more likely liable entities are to try and over-contract, which could lead to the cost of contracts increasing and to contracts becoming more scarce.

With regard to the interaction between AEMO and the AER concerning the triggering of the RRO, one way to think about the circumstances is that absent a trigger, where AEMO forecasts a material risk of the reliability standard not being met, AEMO will seek to procure sufficient RERT coverage to meet the reliability standard. The triggering of the RRO increases the obligation on each market participant to contract, with the aim of reducing the required RERT, and also means that the costs of RERT procured by AEMO will not be spread across all market participants in a region, but will be focussed on those participants who have not procured sufficient coverage. Given the potential magnitude of RERT costs that non-compliant parties would face, we see a need for an urgent consultation process to take place between AEMO, the AER and all Market Participants to ensure that both AEMO and the AER have the best information possible for their forecasts and that the deliberations of each entity and their logic in supporting or not supporting a trigger is made available to the Market in as transparent and open a way as possible.

The Cost Recovery Paper

Rio Tinto remains concerned that one of the outworking of the RRO will be the closure of a material gap by reducing demand rather than by increasing supply. Those end users of electricity who are not entitled to access a regulated or default price could find that retailers or the broader market withdraw their willingness to offer coverage either at all, or at a competitive price. Given the potentially very high cost of compliance and the uncertainty an end-user would face in predicting the proportion of compliance costs attributed to their load, end-users could be left with no option but demand reduction as a means of avoiding compliance costs. Whether this is positive or negative depends on the extent to which it leads to controlled demand management such as load shifting or to inefficient demand destruction.

As set out in the Cost Recovery Paper and as the drafters of methodologies to determine accountability for transmission costs in multiple jurisdictions can testify, the issue of who contributes most to the peak is not an easy question to answer. The right question is how can the choice of pricing methodology best ensure the objective of increased supply and/or managed demand reduction, rather than demand destruction and of minimising costs socialised to compliant entities.

RioTinto

In forming our views on the specific issues raised in these papers we have made assumptions about how these issues fit into the overall framework of the RRO, which may or may not align with the ESB's intent. We would welcome the opportunity to discuss this submission or other design elements of the reliability obligation further with you, and look forward to the opportunity to work with you in the future as the overall structure of the RRO develops. If you have any questions in the interim, please contact Daniel Woodfield (Daniel.Woodfield@riotinto.com).

Yours sincerely

A handwritten signature in blue ink, appearing to read "Brad Haynes", with a long horizontal flourish extending to the right.

Brad Haynes
Vice President
Corporate Relations Australia

Attachment 1: Detailed comments on Grandfathering of pre-existing contracts

For facilities with long term pre-existing contracts, it is fundamental that those pre-existing contracts (including retail contracts) are grandfathered so that they are qualifying contracts. This concern was acknowledged in the design of the reliability obligation presented to the Council of Australian Governments (“COAG”) Energy Council in the ESB Paper “*National Energy Guarantee Final Detailed Design*” dated 1 August 2018 (the ‘Final Guarantee Design’).. The Final Guarantee Design set out that these typically bespoke complex contracts will not require a firmness test. Rio Tinto supports this approach.

The Firmness Paper does not specifically engage with the grandfathering of qualifying contracts. Accordingly, we are very keen to discuss the particular legislative drafting of the Rules that will record the grandfathering mechanisms in order that the policy intent is achieved and to minimise unintended consequences.

Some specific considerations arising out of the particular circumstances of different types of long term contracts are set out below to assist in drafting this provision in the Rules. In particular, it is important that the drafting will need to ensure that the grandfathering means large customers are fully able to satisfy all of their obligations in respect of fees, charges or costs associated with the reliability obligation for the volume and term of their applicable qualifying contracts, without the risk of additional cost-pass through.

Specific circumstances that need to be considered as part of grandfathering contracts

Situation 1: Large load with long term contract – liable entity that purchases electricity under contract is market customer contracted with a market generator.

The primary issue to manage is that while these contracts are qualifying contracts, the long term contracts may potentially be extended and/or expanded or assigned to third parties, whether by virtue of an option in the contract or by mutual agreement between the parties. Accordingly the grandfathering will need to recognise the agreement, as amended and restated from time to time, without specifying particular volumes or terms and needs to accommodate “successors at law”.

Situation 2: Large load with long term contract – contracting entity is large customer with retailer who is market customer.

In the event that a large customer opts in under Section 14E to become the liable entity, long-term retail contracts (3+ years) must be a qualifying contract so that the large customer as the liable entity is able to meet their obligation under the reliability obligations by the existence of this contract.

Situation 3: Whole of the large load connected under complex historical arrangements to be grandfathered

Where a Registered participant is the liable customer for a liable load associated with complex historical arrangements between multiple counterparties (for example, exempt generation agreements) which provide for the connection of the whole of a large liable load, the grandfathering should apply to the whole of the large liable load at the relevant NMIs.