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Energy Security Board

Via email to: [info@esb.org.au](mailto:info@esb.org.au)

## **Pacific Hydro Australia and Tango Energy Response to Capacity Mechanism Project Initiation Paper**

Pacific Hydro Australia and Tango Energy thank the Energy Security Board (“ESB”) for the opportunity to make this submission on the Capacity Mechanism Project Initiation Paper<sup>1</sup> (“Initiation Paper”).

Founded in 1992, Pacific Hydro Australia is a leading owner, operator and developer of renewable energy assets. It operates a high quality, diversified portfolio of wind, hydro and solar assets with an installed capacity of 665 MW; it also has a development pipeline of substantial projects totaling over 1100 MW of potential capacity, as well as over 300 MW of energy storage solutions. It also has a wholly-owned electricity retail business, Tango Energy, with over 150,000 customers as of January 2022. With a strong reputation for engaging and collaborating with the communities where it operates, Pacific Hydro has a track record of delivering lasting, sustainable benefits. Its operating assets currently abate over one million tonnes of greenhouse gas pollution every year.

We are committed to accelerating the decarbonisation of Australia’s energy system, while maintaining a secure, affordable and reliable supply of electricity for customers.

### **General concerns and comments**

In Pacific Hydro and Tango Energy’s previous submission to the ESB on its Market Design Consultation Paper<sup>2</sup>, we considered that the merits of the ‘no-change’ scenario from existing arrangements with the financial Retailer Reliability Obligation (“RRO”), had not been adequately considered. We would like to reiterate these concerns in light of the ESB’s proposed approach.

In considering the objective of the capacity mechanism, we consider that it needs to:

- Minimise the impact on overall cost to consumers; and
- Allocate risks efficiently and fairly to participants, so that the market functions as it is intended; this includes ensuring equal application of enforcement and penalties on the demand and supply sides of the market.

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<sup>1</sup> <https://www.energy.gov.au/government-priorities/energy-ministers/priorities/national-electricity-market-reforms/post-2025-market-design/post-2025-market-design-capacity-mechanism-initiation>

<sup>2</sup> [https://web.archive.org/awa/20211005065856mp\\_/https://energyministers.gov.au/sites/prod.energycouncil/files/publications/documents/86.%20Tango%20Energy%20Response%20to%20P2025%20Market%20Design%20Consultation%20Paper\\_0.docx](https://web.archive.org/awa/20211005065856mp_/https://energyministers.gov.au/sites/prod.energycouncil/files/publications/documents/86.%20Tango%20Energy%20Response%20to%20P2025%20Market%20Design%20Consultation%20Paper_0.docx)

As detailed in our comments in this submission, we consider that none of the options presented appear to solve the issue without significant risks to cost, efficiency being traded off for greater reliability due to an impact on the energy spot price and retail competition resulting in overall higher costs for the system. Therefore, we ask the ESB to consider these in light of the National Electricity Objective and any subsequent detrimental impacts on consumer affordability. We suggest that the ESB consider the financial RRO “base case” and how these may complement jurisdictional initiatives such as the firming infrastructure targets in the NSW Electricity Infrastructure Investment Act, and proposals made in the ESB’s workstream on essential system services<sup>3</sup> as an alternative proposal.

Notwithstanding, in response to consultation question 2, if we are to select a preference among the 3 proposals provided by the ESB (Options 1A, 1B and 2), we believe Option 2 strikes the most appropriate balance in achieving the ESB’s objectives. Our second preference is for Option 1A. While the 3 options appear to have a focus on improving reliability, Option 2 would meet the outcome sought best by allowing AEMO to determine what is needed in line with jurisdictional and Governmental standards. Option 1A, while not preferred, would at least result in a more efficient allocation of risk by allowing market participants on the demand side to control, to some extent, the risks being placed on them.

### **Minimising the impact on overall cost to consumers**

The National Electricity Objective (NEO) considers the price of the supply of electricity as a cornerstone principle. In this context, we do not see how any of the options presented would not result in an increased cost to serve for retailers, with increased costs eventually being passed to customers. Furthermore, this is likely to have negative impacts on retail competition, as small retailers are unlikely to have generation assets in their portfolio that offset this additional cost. At present, smaller retailers have generally cheaper market offers<sup>4</sup>. If an unintended result of the capacity mechanism is to create greater barriers to retail entry by disproportionately impacting the margin of smaller retailers, then this may subsequently result in consumer detriment.

We understand that the capacity mechanism is being envisaged as a separate capacity market, and in our view further detailed modelling work needs to be undertaken by the ESB and provided to market participants to demonstrate the cost impacts on the overall market. The proposals also raise concerns about the impact on the ability of smaller retailers to hedge, in particular if the design of the capacity market certificate trading scheme dictates how, when and where retailers must procure their certificates from.

To mitigate these impacts, we consider that any capacity mechanism should have the following characteristics:

- Suppliers should be required to commit to providing capacity and trading in the market, with a strict auditing and compliance framework so that all available capacity is committed. This will act to minimise the risk of any negative impacts on the stability of the spot price.
- We also suggest a decreased energy spot market price cap to manage any potential price risk, and to mitigate potential increased volatility and disproportionately increased

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<sup>3</sup> <https://esb-post2025-market-design.aemc.gov.au/essential-system-services-and-scheduling-and-ahead-mechanisms>

<sup>4</sup> P6, [https://www.esc.vic.gov.au/sites/default/files/documents/Victorian-Energy-Market%20Report-2021-20211130\\_0.pdf](https://www.esc.vic.gov.au/sites/default/files/documents/Victorian-Energy-Market%20Report-2021-20211130_0.pdf)

exposure for smaller retailers. We note there are precedents for a decreased spot market price cap in other markets where capacity mechanisms exist.

- We support any proposals that would increase liquidity and price transparency, including the proposed centralised auction approach with published, transparent pricing, and further suggest the consideration of reverse auction as an option.
- As gentailers with a firm generation asset portfolio may use generated certificates to satisfy their obligations first, the risk of small retailers without a firm generation asset portfolio having to pay a premium for the residual certificates should be mitigated by limiting transfers of capacity certificates between related parties, potentially by requiring all capacity certificates created to be sold through a centralised exchange.

## **Allocation of risks**

### ***Over-procurement and allocation of risks***

In our opinion, the 3 proposals suggested by the ESB (Options 1A, 1B and 2) appear to risk encouraging over-procurement of capacity, resulting in procurement at an inefficient level. As the ESB acknowledged in its consultation paper, governments will intervene if they believe there is a reliability issue, and the requirement for the capacity mechanism to address reliability, weighed up against the need for a cost-efficient solution, as its most important consideration should be acknowledged in the choice of any capacity mechanism design. Within these proposals, it is therefore important that an efficient allocation of responsibilities and risks to the participants occurs, and that participants that are allocated risks (i.e. exposures, and the requirement to procure certificates) are able to manage them in order to ensure that the market functions as it is intended to, and to continue to meet the outcomes while striking a balance between cost and efficiency.

If similar penalties to the existing financial RRO are considered, allocation of the compliance penalties to retailers in Options 1A and 1B would then serve to shift the risk, bias, and consequences of over-forecasting and over-procuring created by governments to retailers, without adequate incentives. This appears to be inconsistent with an efficient allocation of risks. Therefore, we consider that governments and a centralised quasi-governmental body (i.e. AEMO), are best placed to consider and implement the level of reliability desired by governments. We consider that the centralised forecasting model (Option 2) is most suited to this purpose. We set out our suggestions in further detail below.

### ***Forecasting, and consideration of models 1A, 1B and 2***

In respect of forecasting at risk periods (consultation question 9 and 11), we acknowledge it is a challenge to strike an ideal balance between the historical data and forward-looking methodologies. We have a preference for the forward-looking simulation model. AEMO has the best visibility of how the overall system is changing, and hence, how the nature of the “at-risk” periods may change, and any changes to transmission constraints, through its forecasting publications (e.g. the annual Electricity Statement of Opportunities, and Integrated System Plan) and capability. In addition, using actual data to calculate at-risk periods and then factoring in transmission constraints without appropriate adjustments (questions 14 and 15) risks penalising supply-side certificate creators, i.e. generators, for actual performance factors which may be outside of their control (e.g. curtailment due to unplanned transmission outages), and may impact the efficient allocation of risk to generators. We consider that

AEMO is best placed to forecast capacity needs from an overall system view, making annual adjustments in response to system wide data and overall trends and shifts in the at-risk periods or transmission constraints.

Similarly, in the consideration of options for a capacity mechanism (questions 3 to 6), we consider that AEMO is best placed to forecast the level of capacity that is needed based on its determination of the “at-risk” periods and relevant physical transmission constraints. As the ESB acknowledges, forecasting customer load ex-ante can be considerably difficult for retailers in a retail market marked by constant and significant regulatory changes, and the difficulty is exacerbated for smaller retailers entering a rapid growth phase with innovative and new products.

We urge caution in taking the “hybrid” approach considered in Option 1B which requires retailers to procure certificates against a forecast, and consider that this may exacerbate the over-procurement risk. The consequences of over-forecasting are transferred from AEMO to retailers, leaving AEMO with little incentive to forecast accurately. Issues may also arise in relation to how AEMO would transparently and equitably allocate liabilities to each retailer. Depending on the manner and timeframe in which certificates are required to be procured, this could create unnecessary volatility in the market for certificates too.

For both Option 1B and Option 1A, compliance penalties on the demand side are likely to encourage over-forecasting and over-procurement. In Option 1A, the retailer may at least retain some control of its forecasting “lever” and therefore have greater control of its allocated risks. The retailer is able to amend forecasts within forecasting rules and time periods to be determined, or in the worst-case scenario, if a retailer determines it is unable to meet its forecast liability, commence curtailing customer acquisition activities or activate demand-side arrangements with its customers.

### ***Procurement options and compliance***

In our opinion, liquidity and flexibility are important to the functioning of any market design. Therefore, in terms of procurement approaches (question 13), if the decentralised option 1A is chosen we agree with and support the ESB’s view of the importance of liquidity, and the view that liquidity is best supported by a number of mediums of exchange, such as an exchange-based market that suppliers are obliged to participate in. A secondary market for certificates would also increase liquidity and available avenues to securing certificates. Bilateral contracting arrangements between independent parties transacting at arms-length outside of an exchange can be an efficient tool for transacting, but our view is that vertically integrated portfolios should be excluded from entering into such arrangements to ensure adequacy of supply to all market participants.

Our reasons for preferring option 1A over 1B also include that the timeframes for procurement are more likely to align with the investment cycle and risk for that year, and mitigate the risk of a retailer’s liability being significantly different to its actual load contribution. This is particularly important for a smaller retailer entering a rapid stage of growth where the load in one year could be very different to the next. Option 1B, if implemented, must allow for adjustment and flexibility for it to be workable, potentially through a sliding/percentage target mechanism. A rigid target set by AEMO may create unnecessary volatility in the capacity market as retailers may be expected to hedge their entire load and have no option for adjusting their hedging position if the forecast varies significantly.

### ***Compliance approach***

The compliance approach is an important consideration that influences the behaviour and functioning of the market. Any compliance approach should be equally balanced on both the demand and supply sides of the market. In our opinion, in the consideration and discussion undertaken so far it appears that there is an inconsistency with “light touch” regulation being proposed on the supply side (p26 of the Initiation Paper) in contrast to the consideration of heavy penalties and enforcement action on the demand side. This also appears to be misaligned with the intent of the capacity mechanism, which is intended to create an obligation for physical capacity in contrast to the “base-case” of the financial RRO.

We recommend that specific consideration should be given to the components of the design of a proposed capacity mechanism market, and whether compliance options and the approach are suitable and can work together. For example, if liable entities must cover actual demand, then punitive compliance without adequate flexibility does not seem to be a suitable approach where an ex-ante forecasting approach is adopted, as forecasts are never entirely accurate. On the other hand, a strong punitive compliance regime to discourage under-procurement may be desired if reliability takes precedence over other considerations.

We also recommend that sufficient and greater focus should be placed on the development of a supply-side compliance and audit regime which ensures that availability being paid for by market participants is actually available, and mitigates the risk of strategic bidding behaviour. We consider that this can be achieved by monitoring compliance and enforcing the proposals for preventing market power mentioned in 5.5 of the Initiation Paper, with equal and balanced application of any punitive enforcement penalties on both the demand and supply sides by the relevant regulatory authority. On the other hand, a “lighter touch” approach could be applied equally to both the demand and supply sides, with financial incentives used to incentivise participants to meet their obligations. In the short term, MT-PASA and ST-PASA compliance and enforcement should continue to be a focus, and we hope to have further dialogue with the ESB on this topic in the near future.

If you would like to discuss this submission, please contact Shawn Tan at first instance at [stan@tangoenergy.com](mailto:stan@tangoenergy.com) or on 03 8621 6476.

Yours sincerely,

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