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Australian Energy Regulator  
GPO Box 520  
Melbourne VIC 3001

Submitted by email: [RRO@aer.gov.au](mailto:RRO@aer.gov.au)

Dear Sir/Madam,

**Re: For Consultation – Draft Interim Contracts and Firmness Guideline**

Flow Power welcomes the opportunity to make a submission in response to AER's Draft Interim Contracts and Firmness Guideline (**Paper**).

Flow Power is a licenced electricity retailer that works with business customers throughout the NEM. Our customer base is made up of large commercial and industrial customers who have made a conscious decision to manage their electricity cost using tools most retailers use. As a result, our electricity supply agreements with those customers have been purposely designed to manage our exposure to the volatility of the spot price by passing through the spot price to the customer.

Customers who have chosen to be exposed to the spot price want to be involved and take control to reduce their power bills. They manage their exposure to spot price volatility through physical or financial hedges.

- A physical hedge takes the form of a demand response or onsite generation.
- A financial hedge may include purchasing financial hedges from markets such as ASX Energy Futures or entering into a PPA with generators.

The result delivers to the customer significant savings and supports the intent of the National Electricity Amendment (Retailer Reliability Obligation) Rule 2019 (**Rules**).<sup>1</sup>

We commend the AER for its engagement with stakeholders in the development of the Contracts and Firmness Guidelines (**Guidelines**). We recognise the challenges the AER is facing in finalising the Guidelines within tight deadlines to support the implementation of the Rules.

Appendix 1 provides comments and feedback to the questions raised in the Paper.

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<sup>1</sup> For current purposes we are assuming that the National Electricity Amendment (Retailer Reliability Obligation) Rule 2019 will be made in the form most recently circulated by the Energy Security Board on 5 June 2019.

Flow Power will be pleased to meet with the AER to further discuss this submission. Please contact Nabil Chemali, on 0417 971 032 or [nabil.chemali@flowpower.com.au](mailto:nabil.chemali@flowpower.com.au).

Yours sincerely



Matthew van der Linden  
Managing Director  
Flow Power

## Appendix 1

### Question 1: Classification of standard and non-standard qualifying contracts

- We understand the AER was open to the idea, put forward during the workshop on the Guidelines held in Melbourne Friday 14 June 2019, that options may be included in both standard and non-standard qualifying contracts lists and if the liable entity utilises the non-standard qualifying contract classification then a bespoke firmness methodology must be developed.
- In line with this concept, we recommend the same can apply to power purchase agreements and demand response contracts.
- We submit the AER should classify energy supply agreements that pass through spot price volatility risk to the customer as a qualifying contract. Our response to question 3 below provides explanation of our reasoning.

### Question 2: Firmness as the product of volume risk, price risk and other contract limitations

- We support the AER's consideration that the overall firmness factor is the product of volume risk, price risk and other contract limitations.
- Section 7.3 of the Paper sets the inputs the liable entity must consider when calculating the firmness factor of non-standard qualifying contracts. In all cases, none of the inputs address the price risk. For some contracts, such as the demand response products, the spot price level that triggers the activation of the product plays a role in determining the firmness factor. We submit that the AER should review the inputs associated with each non-standard qualifying contract and where appropriate include an input to test the product's price risk.

### Question 3: Energy supply agreements that pass-through spot price volatility risks to the customer – how do they fit into the qualifying contract framework?

#### 1. Spot price contracts

When a retailer and a customer enter into an electricity supply agreement, what they are agreeing is that the retailer will sell and the customer will purchase the electricity that is supplied (not by the retailer, but by the customer's distributor) to the customer's connection point.

As the customer's retailer, the retailer has to purchase from the wholesale exchange the electricity that the retailer sells to the customer. The retailer does this by becoming or being the financially responsible market participant for the customer's connection point.

In the wholesale exchange, the price payable by the retailer for that electricity is the spot price.

Traditionally, the price payable by the customer to the retailer under their electricity supply agreement is a fixed price.

However, an alternative possibility is that the retailer and the customer will agree that the price payable by the customer is to be the spot price.<sup>2</sup>

From here, we refer to the traditional type of electricity supply agreement as a **fixed price contract** and to the alternative as a **spot price contract**.

<sup>2</sup> The price payable by the customer is likely to include a margin on top of the spot price or some other charge, so that the retailer is compensated for the obligations it takes on under the electricity supply agreement. We won't make mention of this again, as it is not relevant to the analysis.

## 2. Spot price contracts are qualifying contracts

Under section 14O(1)(a) of the National Electricity Law, a contract is a qualifying contract of a liable entity if the following conditions are met:

- the liable entity is a party to the contract;
- the contract is directly related to the purchase or sale, or price for the purchase or sale, of electricity from the wholesale exchange during a stated period; and
- the liable entity entered into the contract to manage its exposure in relation to the volatility of the spot price.

For the following reasons spot price contracts meet each of those three conditions and it follows therefore that spot price contracts are qualifying contracts:

**2.1** As a liable entity, a retailer is a party to the spot price contract as required by the first condition.

**2.2** The electricity that is sold by the retailer under a spot price contract is purchased by the retailer from the wholesale exchange. Furthermore, the price payable by the customer is the same spot price payable by the retailer in purchasing the electricity from the wholesale exchange. Therefore, there is the necessary direct relationship required by the second condition.

Insofar as the second condition contemplates a “stated period”, that period would be the term of the spot price contract.

**2.3** By entering into an electricity supply agreement and by becoming or being the financially responsible market participant for the customer’s connection point, the retailer will purchase from the wholesale exchange the electricity the retailer sells to the customer. Therefore, the retailer is exposed in relation to the volatility of the spot price.

There are various ways for the retailer to manage that spot price exposure and various potential counterparties to contracts that a retailer may enter into to manage that exposure.

If the retailer’s electricity supply agreement with the customer is a fixed price contract, the retailer may buy a swap contract with a generator or with a financial intermediary.

The retailer may also enter into a demand side participation contract with the customer, under which the customer agrees to curtail its load, e.g., when spot prices are high.

Another way to contractually manage the retailer’s spot price exposure, with the customer again being the counterparty, is for the retailer to enter into a spot price contract with the customer. That way, for every dollar that the retailer must pay AEMO for each MWh of electricity the retailer purchases from the wholesale exchange, the customer will pay a dollar for the corresponding MWh of electricity that the retailer sells the customer. This way the retailer perfectly manages its exposure in relation to the volatility of the spot price.

Put another way, under a spot price contract the retailer both secures the role of being the customer’s supplier and manages the retailer’s resultant spot price exposure.

It is beside the point that it is entering into the spot price contract that gives rise to the retailer’s spot price exposure. What the third condition in section 14O(1)(a)(ii) requires is that the contract is entered into “to manage” that exposure, and that requirement is met: the retailer is not just entering into any electricity supply agreement with the customer, it is entering into one under which the price that the customer must pay must be the spot price, and the reason for requiring that to be the price is because that is the means by which the retailer manages the retailer’s spot price exposure.

### 3. AER's role in providing guidance

Under clause 4A.E.1(a)(1) of the Rules, the AER may include guidance in the Guidelines for liable entities to determine whether a contract or arrangement is a qualifying contract.

We submit that the AER should include guidance to the effect that spot price contracts are qualifying contracts.

The AER could do so by including the following statement in the Guidelines:

*A spot price contract to which a liable entity is a party is a qualifying contract for the liable entity. For these purposes, a **spot price contract** is a contract or other arrangement under which a liable entity sells electricity to another person that the liable entity has purchased from the wholesale exchange, at a price which transfers to the other person all of the liable entity's exposure in relation to the volatility of the spot price.*

### 4. Investment principle

In providing guidance under clause 4A.E.1(a)(1) of the Rules, the AER is required by clause 4A.E.1(b) to have regard to the principle that, to be a qualifying contract, a contract should support – directly or indirectly – investment in plant or other arrangements that can: (a) supply energy that may be dispatched; or (b) reduce demand of energy that may be activated.

For the following reasons, we submit that spot price contracts do support the investment contemplated by clause 4A.E.1(b) of the Rules and also that, by directly driving customer behaviour, spot price contracts do so more effectively than other forms of qualifying contracts including swaps bought by retailers selling their electricity at fixed prices. It follows that the AER is able to include in the Guideline the guidance set out in paragraph 3 above:

- As noted in paragraph 2.3 above, when an electricity supply agreement is a fixed price contract, the retailer may buy a swap to manage the retailer's spot price exposure. The retailer's swap undoubtedly is a qualifying contract. This is the case even though there is no promise that the seller of the swap will, for example, invest in generation. Rather, the legislation in effect assumes that the swap will support such an investment. This could be the result, for example, if the counterparty to the swap is a generator, and the generator sells the swap so as to secure a fixed price for new generation, in which case the investment support provided by the swap would be direct. If the counterparty were a financial intermediary, the support provided by the swap necessarily would be indirect.
- When the retailer's electricity supply agreement with the customer is instead a spot price contract, the retailer's spot price exposure is transferred to the customer. The customer therefore is placed in the same exposed position as a retailer under a fixed price contract, with the same motivation to manage the spot price exposure.
- The customer may do this by buying a swap contract with a generator, retailer or financial intermediary, providing just as much support, directly or indirectly, for investment in generation as does any swap that a retailer with fixed price contracts may buy to manage its spot price exposure.
- But there are also other means available to the customer to manage its spot price exposure, which more directly support the investment the legislation aims for.
- For example, a customer with a spot price contact may already have or choose to install its own on-site generation and run that generator when spot prices are high.
- Alternatively, the customer may invest in new plant and infrastructure which the customer can activate to reduce the customer's demand for electricity in response to load curtailment signals, including high spot prices.

- Direct investment of that kind can and will be made more cost effectively and in a shorter timeframe than any investment in new generation that, in practice, may or may not be the indirect result of a bought swap. Being direct, and scaled to the customer's own load, the investment is a straight-forward one that the customer is fully motivated to make so as to see its spot price exposure managed. The customer does not have to grapple with the same difficulty that investors in new generation face, unable to close their investments until after they have sourced swaps with a portfolio of counterparties whose disparate loads collectively match their forecast generation.

#### 5. Spot price contracts as standard qualifying contracts

Under clause 4A.E.8 of the Rules, the Guidelines must include types of contracts that constitute standard qualifying contracts, for which the Guidelines must include default firmness methodologies. Those methodologies must be consistent with the firmness principles detailed in clause 4A.E.3(a) which are largely concerned with the extent to which a qualifying contract reduces a liable entity's exposure to the volatility of the spot price.

We submit that the Guidelines should include a spot price contract as a standard qualifying contract, since it transfers all of the liable entity's exposure to the customer.

#### 6. Firmness factor

We submit that it follows from the following points that the default firmness methodology to be included in the Guideline for spot price contracts, as standard qualifying contracts, should be that such contracts have a firmness factor of one.

- Because spot price contracts require the customer to pay the spot price for all of the electricity supplied to the customer, the retailer is left with no price risk.
- Because spot price contracts cover all of the electricity supplied to the customer, there is no volume risk.
- There are no contract limitations with spot price contracts: there is no maximum payout limitation after which the retailer might have to pay the spot price, no weather event related caps and no other contract coverage limitations. Put another way, there are no other contract limitation risks.

#### Question 4: Format of the NCP

We note the sheer volume of data the liable entity must report, especially after implementation of the 5-minute settlement.

We suggest, where appropriate, the AER to provide Excel templates for the liable entity to utilise for reporting purposes. We consider the reports listed under examples 2, 4 and 5, Section 8.1.2 of the Paper to be appropriate.

#### Question 5: Auditors Panel

In establishing and maintaining the Auditors Panel, the AER has proposed to have regard to:

- The need for a person to have sufficient experience and expertise in energy derivatives and energy contracts; and
- Whether the person is an independent person.

In addition to the above, we submit the AER should also have regard to the need for a person to have:

- Detailed knowledge of and capability in interpreting market rules.

- Sufficient knowledge of market operation and supply-demand interaction.
- Thorough understanding of different type of generation.
- Understanding of physical curtailment.