



Energy Retailers Association
of Australia Incorporated

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Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
SOUTH SYDNEY NSW 1235

By email: submissions@aemc.gov.au

**Re: Review of energy market frameworks in light of climate change policies -
2nd Interim Report (EMO 0001)**

Dear Dr Tamblyn,

**Re: Review of energy market frameworks in light of climate change policies -
2nd Interim Report (EMO 0001)**

The Energy Retailers Association of Australia (ERAA) welcomes the opportunity to again contribute to the AEMC's consultation into the impacts of the climate change policies on energy markets.

Our comments are presented below in order of decreasing priority for retailers.

Regulated retail prices

The risks and inefficiencies of retail price regulation (particularly under the CPRS) remain a major concern for retailers. In particular, the inability of existing regulated tariff setting processes to adequately deal with cost increases and volatility associated with the CPRS and eRET are a real threat to the ongoing viability of the retail sector.

In order to better understand the potential impacts of the CPRS related to regulated retail pricing, the ERAA engaged Farrier Swier to explore these matters in some depth. The report from this research assignment is attached for consideration by the AEMC.

We note that Farrier Swier have reached similar conclusions to the AEMC (and its advisor Frontier Economics) on the implications of the CPRS for regulated tariff setting. In particular, that:

- Carbon forward markets are undeveloped and will not allow adequate management of carbon price exposures in the early years of the CPRS;
- Forecasting carbon prices is significantly more challenging than forecasting NEM pool prices due to:
 - Reliance on complex immature international carbon markets; and
 - Exposure of carbon price to regulatory and policy changes in other countries.
- CPRS costs will become a significant and volatile component of energy costs;
- Historic approaches to regulated tariff setting are insufficiently flexible to ensure sustainability of retailers through this transition period.

The long term ERAA position is that the preferred approach to dealing with this issue would be to remove retail price regulation. However as noted by the Commission, we are aware that ultimately this decision is the responsibility of state governments and it would appear that several of these jurisdictions plan to maintain retail price regulation in the near term.

In this environment the AEMC's recommendations to introduce greater flexibility into regulated retail tariff regimes where they continue are sound.

Proposed models

The ERAA is supportive of Model 2 (retailer adjustment within pricing period) as this would help mitigate some of the risks associated with the introduction of the CPRS by allowing retailers to adjust the retail price in response to changes in wholesale costs. An area of concern related to this model however, is the proposal for an ex-post price true-up at the next tariff review. This part of the proposal is unworkable, as it attempts to impose a "network" style true up arrangement (which can work for monopoly businesses where customers cannot move), but cannot work in a contestable markets, where true-up would apply across different customer bases. Any check process performed by regulators on retailer initiated prices should be initiated early and avoid any concept of a true-up mechanism.

A serious limitation with the proposed Model 1 is that retailers would potentially have to endure significant losses until the six-monthly review and the subsequent resetting of the price. Depending on the magnitude of these losses, this could put many retailers in a precarious position, particularly given the anticipated increased prudential burden as a result of the climate change policies.

A further critical parameter relevant to both models is the definition of the threshold outside of which costs would need to fluctuate prior to an adjustment being allowed. This makes the determination of the threshold critically important, since if it is made too broad retailers will under-recover significant costs. Another concern is that a sustained increase in costs just below the threshold would prove detrimental to retailers as there would be no way of recovering these costs. We therefore consider that the proposed model should account for such possibilities. Details of how this could be managed would be determined in the implementation phase.

Generation capacity in the short term

Reserve contracting

The ERAA is not supportive of the reserve contracting mechanisms outlined in the Report. In our view these mechanisms will simply extend/amplify the well known distortionary effects of the Reliability Emergency Reserve Trader (RERT). The application of the standing reserve and prolonged targeted reserve seem impractical as they will require an investment in reserve capacity well ahead of dispatch – i.e. before the risk of any shortfall in generation can be adequately assessed. This increases the likelihood of customers bearing the cost of reserves that ultimately are not utilised.

Additionally, the adoption of these mechanisms could result in demand side participants withdrawing their output from the market to enter reserve contracting arrangements where the revenue stream is more certain. Given most market participants strong opposition to the RERT due to its distortionary effects, the contemplation of these equally distortionary mechanisms is a step backward.

Of particular concern to retailers are the unhedgeable costs that invocation of reserve trader events incur. These costs need to be passed through to customers, and create significant problems for the industry given the reasonable expectation of customers to face only contracted costs – and not large unexpected surcharges. Clearly in areas where retail price regulation exists – these costs need to be born by retailers directly.

More accurate reporting of demand side capability

In principle, increased accuracy in the estimation of demand side capability would assist AEMO in deciding when to invoke market interventionist mechanisms such as the RERT in response to any capacity shortfall. While this is a sound objective, the ERAA remains unconvinced that increasing obligations on retailers in this area will yield substantial benefits, given that retailers already report such information to the market operator through the existing SOO process. We therefore urge the AEMC to consult with relevant market participants including retailers to determine among other things what information is available, who has it, what format it can usefully be provided to the AEMO, and what practical steps can be taken to improve the overall process. This work must establish that the benefits for more information in this area will overcome the administrative costs of collecting such data. No analysis of either the costs or practicalities of this proposal appears to have been performed to date.

Load shedding management

This proposal as we understand it involves the upfront payment to market customers for making their load centrally dispatchable, with a further payment (based on their 'declared value of customer reliability') to follow if the load is actually dispatched.

The AEMC states that load shedding management (LSM) is a more economic and socially desirable outcome than involuntary load shedding. Whilst we agree that

involuntary load shedding presents a number of public relations challenges, we are strongly opposed to the LSM and see no sound rationale (economic or social) for its implementation.

According to the AEMC the LSM is economically desirable because it provides an avenue for customers to declare their value of reliability and be compensated in accordance with their value. This approach is inconsistent with other elements of the market design in which service providers are paid the market value of their services, not whatever value they choose to nominate (ie. we do not have a “pay as bid” market).

As it stands customers have an incentive to enter into contracts with retailers to shed load when it is in their commercial interest to do so, similarly retailers have an incentive to enter such contracts to minimise their exposure to high spot prices. Market interventionist mechanisms such as the LSM can only be justified when there is a clear market failure. We assume that the AEMC sees the distortions created by the Market Price Cap as warranting this intervention, although more clarity on which market failure the AEMC is seeking to address with this measure is required. We note that the review into demand side participation in the NEM seems to indicate that there are no major impediments to demand side participation.

Given the relative price inelastic nature of electricity demand, it can be argued that relatively high prices would be required to invoke a demand side response – possibly higher than the market price cap (MPC). If the underlying issue is that the MPC is not high enough to encourage more demand side participation, then this issue should be examined separately, and not addressed via the LSM. In any case, it is our understanding that the Reliability Panel undertook substantial work to determine the appropriate level of the MPC and considered that the costs of a higher cap outweighed the benefits (including bringing more demand side into the market).

Like the RERT the LSM is inefficient and distortionary, whereby contracted load would receive an upfront fee for making load dispatchable, and then potentially large payments based on the ‘declared value of reliability’ if used. These costs would then be recovered by an uplift on market customers (including retailers). Unpredictable and unhedgeable costs of this nature are undesirable and bring the industry into disrepute when retailers are forced to recover them from end use customers (which is a socially undesirable outcome). The LSM could also disincentivise interruptible load from entering into market contracts with other participants (such as retailers) as they may well opt to take the chance of receiving uncapped returns if an LSM arrangement is invoked, rather than entering the market were returns are limited by the Market Price Cap and other reliability settings.

Overall, the ERAA does not support the LSM proposal and recommend that it is not recommended to the MCE.

Connecting remote generation

The ERAA has previously expressed support for the general concept of the Network Extensions for Remote Generation (NERG) particularly given the market failures

associated with the connection of remote renewables to meet the expanded Renewable Energy Target (RET). Whilst we are pleased that the AEMC has opted to progress the development of Option 2, we still remain concerned about the lack of clarity surrounding how NERG zones will be chosen and the implications for the long-term interest of customers.

The 2nd Interim Report states that the Australian Energy Market Operator (AEMO) and Network Service Providers (NSPs) each have a role in planning NERGs whereby the AEMO will identify potentially economic geographical locations. In making its assessment the AEMO would have regard to the amount of possible generation capacity in an area and whether the likely generation is sufficiently remote. This according to the AEMC would enable NERG development to be strategically focused on locations with the best prospects for developing efficient outcomes in the National Electricity Market (NEM). These criteria in our view are vague and leave some key questions unanswered and may incentivise overbuild over the level required for committed generators. A key component of any NERG assessment should include the number of connection enquires from generators and for any overbuild to be determined on the basis of cost benefit analysis. Such consideration encourages investment efficiency and ensures equitable share of the cost and risk by the committed generators. Other concerns on the assessment include the type of renewable energy, i.e. baseload vs. intermittent and issues surrounding reliability, congestion and ancillary services.

Given that under the NERG framework consumers will bear the risk of stranding it is imperative that the NERG selection process is transparent. Though much of the details can be espoused in Guidelines by the AEMO/Australian Energy Regulator (AER) once any Rule change is enacted it is important that the AEMC clarify the high level criteria for selection and evaluation of NERG's to guide the development of these procedures. Clarity around cost recovery arrangements to ensure a reasonable sharing between customers and connecting generators is also required.

In regard to the proposal for making NERGs contestable, the ERAA is supportive. The development of multiple proposals under a competitive process where the AER chooses the best project should lead to efficiency gains.

Efficient utilisation and provision of the network

The ERAA appreciates the need for appropriate locational signals to maximise efficiency in the market. We also remain concerned that the generation investment required by the CPRS and expanded RET will inefficiently increase congestion under the existing regime.

Despite these concerns we are concerned that that the proposed G-TUOS scheme does not deliver a useful signal to investors due to (amongst other problems) its annual reset (ie. lack of price certainty), and lack of linkage to the investment regime (ie. funds not linked to addressing congestion). We are also concerned that this significant proposal has been launched late in the process and has not had the industry wide debate that would normally be associated with such a significant change to the market.

Further concerns relate to the annual reset and likely instability in the G-TUOS costs that may increase barriers to generation investment and increase generator cost volatility. These outcomes would likely result in increases to premiums demanded by generators through the contract market – thereby directly impacting on retailer (and ultimately customer) costs.

Inter-regional transmission charging


The proposed inter-regional TUOS if applied appropriately should encourage TNSPs to undertake investments which confer inter-regional benefits on the market. This will assist in addressing a key weakness in the transmission planning regime and facilitate activities such as interconnector augmentation, which is critical if regions such as South Australia are to accommodate increasing amounts of wind.

We suggest that the AEMC further explore the potential for price shocks if large inter-regional links cause significant changes to the cost reflective component of customer tariffs in regions where link augmentations proceed. If such shocks are likely, then the benefits of tariff smoothing mechanisms should be considered.

The ERAA welcomes further discussion with the AEMC on the views expressed in this submission, or on other matters associated with the impact of climate change policies on the retail sector generally.

Please contact me on (02) 9437-6180 to facilitate such discussions.

Yours sincerely,



Cameron O'Reilly
Executive Director
Energy Retailers Association of Australia