10 August 2009

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

Dear Dr Tamblyn,

Review of Energy Market Frameworks in light of Climate Change Policies
2nd Interim Report, Reference EMO0001

Integral Energy welcomes the opportunity to provide a submission on the Commission's 2nd Interim Report on its review of the energy market frameworks in light of climate change policies.

Climate change will bring an evolutionary change to Australia's electricity and gas markets. The impacts will occur, not just at the wholesale level, but also in energy retail and distribution. In the short term, the rapidly changing policy environment means increasing uncertainty for energy businesses. In the medium term and beyond, the effects of climate change policies will lead to a more dynamic and challenging operating environment, particularly for distributors and retailers.

Integral Energy has a number of comments regarding the Commission's proposed changes to the energy market framework in order to manage the relevant risks.

Retail risks

Integral Energy welcomes the Commission's recognition that the CPRS and expanded RET will result in large and unpredictable cost increases for retailers. These increases will predominantly flow from increased wholesale energy costs and the direct cost to retailers of climate change policies including acquiring carbon permits and RECs. Increases to prices and price volatility will place pressures on retailers to meet their own, as well as market required, prudential and credit support requirements. This is particularly the case where retail price controls remain in place.

The single most effective step that could be taken to address the issue would be to remove those remaining retail price controls. Under present arrangements, this is a State government decision. However, Integral Energy supports the Commission continuing to make clear the strengths of a fully deregulated approach.

On the assumption that those controls will remain in place, at least for the period during which the CPRS will begin to take effect, Integral Energy submits that retailers must be allowed to pass through the additional costs associated with climate change in full and as swiftly as possible. To this end, Integral Energy supports the Model 2 option identified by the Commission whereby retailers would be able to adjust their own prices in response to carbon-related cost increases. Any ex-post regulatory recalibration would need to ensure that the financial risk to the retailer from the regulator being able to do so was fully compensated.

In terms of the Model 1 option (a regulator initiated adjustment), Integral Energy is currently participating in the Independent Pricing and Regulatory Tribunal's (IPART's) process for determining the regulated retail tariffs to apply in NSW between 2010 to 2013. Integral Energy has submitted to IPART that the following measures are the minimum required to manage the risk identified above:

- carbon-related cost changes, including those that impact on wholesale energy purchase costs, to be specifically included in the existing pass through mechanism so that any such costs would be addressed as a cost pass through event;
- IPART to adopt the principle that any adjustments arising from such changes will be passed through to customers <u>immediately and in full</u>. Retailers should not have to bear the financial risk associated with absorbing the additional costs or delaying any associated pricing increases until the next annual determination. This would require:
    - a zero threshold for such costs;
    - the immediate passing on of any pricing adjustments; and
    - ensuring that the pass through is applicable to all three years of the determination period; and
- in addition, IPART must conduct six monthly reviews of changes to wholesale energy purchase costs, including changes arising from the introduction of carbon legislation — this would mean a review leading to possible price changes on 1 January and 1 July each year. Again, a zero threshold for such costs should be applied.

Distribution impacts

Integral Energy also agrees with the Commission that the introduction of the CPRS is likely to promote the use and connection of embedded/micro generation and demand management. This will increase the requirements for distribution businesses to more actively manage their networks as variability of flows increase. It is therefore important that distributors have the ability to recover the additional costs required as well manage the potential revenue impact of lower volumes/different customer usage patterns arising as the result of climate change policies. Integral Energy has two specific comments in this regard.

First, to be able to manage the considerable challenges associated with operating a network with a wider generation mix and more dynamic power flows, distribution businesses will be required to invest in new systems and innovative technologies. This includes finding ways to work more effectively with customers to better manage peak demand and encourage greater energy efficiencies. It involves not only within horizon "smart grid" and smart meter technologies but also greater investment in energy storage systems and determining what would be needed to support the adoption of electric vehicles.

As part of the Australian Energy Regulator's (AER's) recent process for determining the regulated network tariffs to apply to apply in NSW between 2009 and 2014, Integral Energy made strong arguments in favour of incorporating innovation allowances that adequately provided for the above. In particular, Integral Energy advocated the adoption of the approach used by the South Australian regulator for ETSA Utilities' 2005 to 2010 network revenue determination, namely, an ex-ante approval of specific innovation projects subject to an overall funding cap. The ETSA Utilities allowance was $20 million. By comparison, the AER innovation allowance for Integral Energy amounted to only $3 million. The difference will inevitably impact the degree to which Integral Energy can prepare for the changes in how electricity is both delivered by networks and used by customers as the result of climate change.

Second, the challenges operating the network may negatively impact on the effectiveness of current incentive regulation mechanisms such as the AER's Service Targets Performance Incentive Scheme and Efficiency Benefit Sharing Scheme. These encourage improved distribution service levels and cost efficiencies but do so on the assumption that there are no exogenous shifts in operating conditions. It will be important that the effect of climate change policies on network performance is explicitly taken into account in applying those incentive schemes. If not, this may adversely impact the distributor's financial viability.

Connecting remote generation

Integral Energy in principle supports the Commission's view that changes to the existing mechanisms would improve the process for connecting remote generation, particularly with regard to clusters of generators in the same location. However, Integral Energy has two comments in relation to the Commission's specific proposals:

- the sizing of the connection assets should be based on AEMO's generation forecasts rather than the AER being able to disallow the project based on the market operator reviewing the network service provider's (NSP's) forecasts; and
- the provision of the connection works should not be contestable — doing so is almost certain not to be cost and time efficient as it would require an additional

layer of contracting and risk management between the contestable service provider and the NSP on top of the contract with the generator.

Short term market measures

The Commission's report makes it clear that AEMO already has a wide range of options to procure reserve. Additional mechanisms are likely to reduce the effectiveness of the wholesale market with flow on consequences for both retailers and downstream customers. As a retailer, Integral Energy is therefore strongly concerned to ensure that a very clear case is made before any additional centralised reserve procurement measures are considered. Any such measures would need to be clearly transitional and as market oriented and cost-reflective as possible. Their triggers would need to be well-defined and set at levels that accurately reflect the risk of market failure. As with the current RERT process, AEMO should be required to canvas both supply and demand side options to address any potential shortfall.

Integral Energy does not support the compulsory provision by retailers to AEMO of information on the demand side arrangements they have with their customers. That information is commercial in confidence. Integral Energy recognises that, as the market continues to develop, greater transparency regarding opportunities to manage demand is likely to evolve. However, any changes in the market framework needed to effect this will require a clear rationale and careful consideration. The same comments apply with respect to the Commission's suggestion regarding centralised load shedding management. Such a mechanism would almost certainly stifle the development of commercial arrangements. The solution to greater market uncertainty is not to override such arrangements without a strong case having first been made and the implications fully considered.

Integral Energy does, however, support both the harmonisation of network embedded generation connection assessment processes and AEMO's processes for registering those generators. These are pragmatic steps that should assist the early availability of additional capacity ahead of potential market shortfalls.

Integral Energy looks forward to the publication of the Commission's Final Report in the coming months. Should you have any questions in relation to the above, please contact Anthony Englund on (02) 9853 6511 or anthony.englund@integral.com.au.

Yours sincerely

Vince Graham
Chief Executive Officer