Response to the AEMC Interim Report for Review of Energy Market Frameworks in Light of Climate Change Polices

20 February 2009

Introduction

Aurora Energy (Aurora) appreciates the opportunity to comment on the Australian Energy Market Commission (AEMC) Interim Report for the Review of Energy Market Frameworks in light of Climate Change Policies ("the Review"). Aurora perceives the Review as an essential step in preparing the Australian Energy Market for the introduction of the Carbon Pollution Reduction Scheme (CPRS) and the expansion of the Renewable Energy Target (RET). However, we believe the Review in its current scope does not fully address all the potential issues to arise in Australian energy markets that could be deemed material. Issues not investigated and/or investigated now may prove difficult to ameliorate post implementation of CPRS and expanded RET.

Aurora Energy

Aurora Energy is a Tasmanian Government-owned electricity distribution and retail company formed in July 1998 pursuant to the Electricity Companies Act and incorporated under the Corporations Law. Aurora also recently secured an agreement on the sale and purchase of the Tamar Valley Power Station. The CPRS and expanded RET have a high potential to impact on Aurora's business interests in the retail, distribution and generation sectors.

Summary

From the discussion that follows Aurora highlights the key points:

- Greater consideration is required of the impact of CRPS and expanded RET on distribution networks;
- There should be clearer articulation of the relationship of the Review to other ongoing regulatory reviews and developments;
- The Review's findings on retail price regulation are sound but in further development should consider the differing levels of retail competition effectiveness across jurisdictions;
- The AEMC should consider how to provide transparency and certainty to retailers in any recommended approach for how the carbon price will be incorporated in existing or revised tariff methodologies;
- The Review should attempt to foster a modern electricity framework that facilitates smart grid technology while being mindful of its potential to impact on current network operations;
- The AEMC has omitted the risk of potential decline in investment in energy networks and the lack of incentives for networks to respond to the challenges of climate change;
- The decline in energy network investment is further exacerbated by the current Australian Energy Regulator (AER) decision on the Weighted Cost of Capital (WACC).

Aurora also notes that the Energy Retailers Association of Australia, the Energy Networks Association and Energy Supply Association of Australia have provided submissions to the Review. Aurora provides broad support to the submissions by these three peak organisations that represent Aurora's concerns.

General Messages

There appears little change in the Interim Report from the Scoping Paper's predominant focus on generation. While there is some consideration of transmission and retail issues there is still a lack of consideration of distribution-related issues. A basic concern is that current connections arrangements may be inadequate to handle a large increase in the number of embedded generation connections driven by the CPRS and expanded RET and additional measures for managing new patterns of congestion may be warranted. Moreover, networks will be required to adapt to climate change whether through the enhancement of existing technology or with a focused drive for the introduction of smart networks and more specifically, smart grids. As it stands, these issues do not receive adequate consideration with the Review. Aurora is also concerned that the expectations of the capability of networks to manage the anticipated increase in installations of embedded generators are unrealistic. That is, the potential take-up of embedded generation will have an effect on networks beyond their design and current capability.

In considering the ability for network businesses to adequately prepare for CPRS and expanded RET, Aurora also wishes to note its strong concern over the AER draft decision on the Weighted Cost of Capital (WACC) for return on investment in network infrastructure. The current draft decision suggests there will be a shortfall in the investment required to maintain network infrastructure at is current levels, let alone the requirements for the advent of CPRS and expanded RET initiatives.

On a general level, Aurora notes the key issues highlighted above are, to a certain degree, also under consideration in other streams, mainly Commonwealth initiated reviews but also some at State level. Hence, Aurora seeks a statement on the progression of the AEMC's Review and how it inter-relates with other Reviews, such as the National Distribution Planning and Connections Framework, the National Framework for Energy Efficiency and other active regulatory reviews.

Issue 1 – Convergence of gas and electricity markets

Aurora reiterates our point from the Scoping Paper that convergence is not occurring in all eastern states. Tasmania's gas market is relatively immature, is deemed 'uncovered' for the purposes of the National Gas Law and gas-fired generation constitutes a small percentage of Tasmanian generation output. We believe the gas market and regulatory arrangements in Tasmania are appropriate and match the current developmental phase of the sector. However, we do note the potential for a convergence of gas and electricity markets to impact on gas prices and regulatory arrangements in the mainland States. That there are potential issues of materiality in a future where the convergence of gas and electricity markets occurs as a result of gas generation growth, due to CPRS and/or expanded RET. Such an outcome could potentially affect Tasmania. Hence we support further investigation of this issue while having regards to jurisdictional circumstances.

Issue 2 – Generation capacity in the short term

Aurora has no comment on this issue.

Issue 3 – Investing to meet reliability standards and increase use of renewables

Aurora considers that the AEMC should give greater consideration to the likely uptake of embedded generation when considering reliability and the installation of renewable energy generation. The current policy climate in Australia is one that encourages the development of feed-in tariffs and the promotion of small-scale renewable energy generation. This is re-enforced by the Council of Australian Governments' (COAG) recent release of national feed-in tariff principles to further encourage small-scale embedded generation. The CPRS and expanded MRET are likely to further accelerate the prevalence of embedded generation, which raises the prospects of opportunities, and risks, that should be considered in addition to the discussion of generation such as wind, solar or other forms.

A concern to Aurora is the potential for embedded generation to significantly impact on the ability of distribution networks to deliver on reliability standards. The automatic connection of embedded generators provides no ability for distributors to manage a clearly identified risk. Installed in small numbers this generation type is unlikely to impact on the network, however, where embedded generators are installed in significant volumes distributors may be challenged by unanticipated technical constraints. There are also significant reporting implications to come from a likely exponential progression of installed embedded generation. It may be necessary to track the power quality and safety performance of such assets as well as carefully evaluating their capacity to ensure their impacts on the network are minimised.

Although it does not necessarily in itself reduce demand, embedded generation has the potential to assist the energy sector in meeting increasing levels of demand. In tandem with smart grids and smart networks, embedded generators could assist in this area. In planning for the future of Australian networks under CPRS/expanded RET there needs to be a balance between positive regulatory encouragement and evaluation of the capabilities of regulatory frameworks to ensure network reliability is not compromised.

Issue 4 – Operating the system with increased intermittent generation

Aurora retains its previous position that this is a material issue and that the current regulations may not be adequate for dealing with the challenges posed by a major increase in intermittent generation. Aurora considers that at the network level there is a risk in the potential for a reduction in reliability to come from increased intermittent generation. The variability of wind generation combined with the likely increase in embedded generation could vastly alter the balance of the generation to load equation. Currently, most embedded generation assets are of such a size that automatic connection is granted. On a singular basis this presents no implications, but in significant numbers embedded generation has the capacity to impact on the operation of energy systems. Clear planning requirements around the types and sizes of generation that could be connected to the network should be developed. These are not present in the current regulatory framework, let alone fashioned in the context of CPRS and expanded RET.

Issue 5 – Connecting new generators to energy networks

Aurora's view is that connecting new generators to the network is a material issue. Aurora again notes the absence of consideration of embedded generation issues as the main gap in this area. There should be further work undertaken to develop the current framework to provide incentives to embedded generation in tandem with the development of monitoring and reporting controls that can assist in evaluating the impact of embedded generation. These tools are essential for ensuring effective progression of concepts such as smart grids.

Issue 6 – Augmenting networks and managing congestion

The issue of augmenting networks and managing congestion is perceived by Aurora as material and requires further investigation. Aurora notes other reviews of congestion undertaken by the AEMC, such as the MCE Congestion Management Review, have identified risks to the efficiency of the electricity market resulting from congestion and further highlight the materiality of this issue. This is truer when considering the risk in congestion increasing due to CPRS and expanded RET and the affect this may have on cost structures of generators and ultimately reduce the liquidity of the contract market. Managing this risk for participants has not been resolved nor has the role of networks in this matter. We believe this issue requires further consideration under this Review. In particular, non-network approaches such as embedded generation should receive the same regulatory approach that is afforded to established network augmentation approaches in terms of delivering required performance requirements.

Issue 7 – Retailing

Aurora supports the key findings identified by the Interim Report in the area of retail price regulation. CPRS will introduce new and uncertain costs into the supply chain for wholesale energy and prudential costs will also be higher. Current retail price regulation is not sufficiently capable to cope with large frequent rapid changes in retailer costs.

However, not all energy markets in Australia are commensurate. Tasmania is a market that is not yet fully contestable, and has not been deemed to have effective competition. Further, there is currently a lack of wholesale market competition in Tasmania. These factors suggest that any approach to pass through of carbon must be taken in regard to local jurisdictional conditions.

Hence, Aurora suggests caution when examining any blanket changes the to the Australian Energy Market Agreement (AEMA). The AEMA has served as a useful tool in progressing the national energy reform agenda over the past five years. The logic around its previous amendment was sound and recognised the individual requirements present in each jurisdiction, such as those around retail pricing which remains in the remit of individual jurisdictions. Given the circumstances in Tasmania we support recognition of the particular market conditions in the various jurisdictions while seeking the creation of a mechanism that allows for the pass through of carbon costs in retail pricing. In the first instance, any new or revised pricing methodology should have a clear and transparent process in its determination and it should be conducted as efficiently as possible. Aurora would also support a process whereby retailers could recover costs in cases where carbon prices turn out to be materially different to those which were used in an initial tariff calculation.

In regards to impact of Retailer of Last Resort mechanisms, Aurora highlights this as another example that is subject to concurrent reviews in the national energy framework. Aurora notes that the inevitable cost rises to come from CPRS, expanded RET, increased network/transmission costs and the likely increase in the cost of energy will put significant strain on retailers across the national energy market. This highlights the requirement for adequate RoLR provisions and the need for cost pass through of the carbon price signal.

Issue 8 – Financing new energy investment

Aurora disagrees with the Review's finding that the current framework will support efficient financing of the significant additional investment implicit in the CPRS. Aurora does not dispute the Report's observations that the current frameworks for regulated investment are robust and capable of sustaining capital investment programs. However, current frameworks do not assist networks in managing CPRS related input costs and there is a material risk that increased CPRS related costs will not be fully recoverable by network service providers. The Review needs to consider this matter, as any perceived increase in risk that costs will not be recovered will have a negative impact on investment in infrastructure. On a basic level, the existing frameworks provide little encouragement to networks to invest in infrastructure that is carbon friendly.

While this perceived deficiency might not arise as a result of CPRS or the expanded RET scheme we believe that there is an opportunity in this Review for the AEMC to provide policy direction to distribution networks in the manner in which they develop their infrastructure, regardless of whether this issue is seen as framework design or content. That is, at the least the Review itself can act as a trigger for a review of this approach to calculating regulated investment.

The current AER findings around WACC are again noted as a point of concern, especially during the conditions prevalent in the current global financial crisis. These findings have a high probability of threatening the requisite risk-reward balance in the regulated energy network sector and therefore undermine future investment in network infrastructure.

Conclusion

In summary, Aurora Energy agrees with many of the conclusions in the AEMC's Interim Report, however Aurora would like to see the Commission give consideration to the materiality of these views as per the objectives of the Review.

Aurora has provided comments on these areas where further investigation of materiality is required. Our concern has focussed on the lack of consideration of network related issues, including the implications from the potential uptake of embedded generation, the current issues surrounding investment uncertainty and the pass through of carbon related costs in retail pricing.

Representatives from Aurora Energy are available should you require to support the submission.

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