Energy Retailers Association of Australia Incorporated

20 February 2009

The Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

submissions@aemc.gov.au

Dear Dr Tamblyn,

Re: Review of energy market frameworks in light of climate change policies – 1st Interim Report

The ERAA welcomes this opportunity to comment on the AEMC's First Interim Report (Report).

Summary

Retail price regulation poses significant risk to the ability of the energy market frameworks to deliver the required investment to satisfy the Carbon Pollution Reducition Scheme (CPRS) and Renewable Energy Target (RET) policy objectives. A policy of de-regulation of retail prices should be adopted across the NEM. If this cannot be achieved in the required timeframe, the AEMC should facilitate development of an approach to ensuring the principle of carbon and RET cost pass-through is practically implemented in the interim.

Clarity on how the costs of climate change related policies will be recovered through regulated tariffs is urgently required, as 2010 regulated prices (which will span the commencement of the CPRS) will be determined late in 2009. Clear provisions dealing with pass-through are needed before this time.

The ERAA also supports the AEMC view that additional regulation of the markets is largely unnecessary, and that market forces within the existing "decentralised decision making framework" is the most efficient way to proceed.

Our views on other key issues in the review include:

- Concern that the proposed enhancement of the Reliability Emergency Reserve Trader (RERT) scheme is unlikely to be effective or efficient;
- Support for further exploration of how economies of scale related to connection of remote renewables can be achieved; and
- Congestion can materially impact on contract market competition and needs to be addressed urgently in the light of the CPRS and RET.

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Our views are set out in more detail below.

Generation capacity in the short term

RERT

The ERAA's stance on market interventionist mechanisms such as the RERT is well known, in that they are distortionary and place undue burden on retailers. We would therefore not be supportive of any attempts to broaden the scope of the RERT or attempts to introduce any mechanism that would have a similar distortionary/burdensome effect.

Whilst it is good risk management to develop mechanisms to deal with any significant shortfall in generation if it were to eventuate, it is important that we do not lose sight of the underlying causes of any potential shortfall in the first place.

Contract market liquidity

In this regard, the illiquidity of the contract market beyond 2010 as a result of uncertainty surrounding the CPRS is hampering investment signals, and will have to be addressed. Whilst it is expected that there will be increased willingness by generators to contract as some clarity around the carbon price emerges, retailers may still be apprehensive to contract if the continuing uncertainty regarding how the carbon price will be passed through into regulated tariffs persists.

Recognising that it is unlikely that retail prices will be deregulated in all jurisdictions by the start of the CPRS it is important that some clarity/transparency around how the carbon price will be incorporated in the existing tariff methodologies be provided.

Potential reserve shortfalls in 2010-11 period & demand side response

In regard to what can be done to address any significant shortfall that may occur in 2010-11, the only options that would appear to be available (given generator development lead times) are demand side options. We are aware that the AEMC has aligned its review into demand side participation (DSP) in the NEM with this Review. While we have yet to have the opportunity to examine the recommendations of the demand side review in detail, it may prove useful to use the outputs from the DSP Review to help inform the design of a demand side mechanism that could address any significant shortfalls as they arise.

As a general point however, the ERAA is of the view that the current market based approach to demand side management in which retailers strike commercial arrangements with demand side suppliers for use in their risk management portfolios is likely to continue to be the optimum way for demand side capability to contribute to the market. Such an outcome is compatible with the NEM designs decentralised decision making model.

Within this context, we note that while some demand side options have been uneconomic in the past, it is likely that they may become competitive if a very tight supply/demand position does emerge in 2010/11. Under these conditions the

value that retailers will be able to attribute to demand side services are likely to increase – which is likely to make these options commercial.

We note that any attempt to force a RERT style mechanism to bring forward uneconomic demand side response would be a demonstration of intervention in the market processes which is likely to be counter-productive in the longer term. This would occur because the intervention would further delay the development of commercial demand side services who may perceive more value in seeking regulated returns via market interventions, than in developing products that would meet demand in the competitive risk management products market.

Connecting new generators to energy networks

Efficiencies can be obtained from enhanced connection arrangements

The ERAA agrees that the connection of new generators to energy networks is an important issue that should be progressed further under this Review. The combination of the RET and the CPRS is expected to significantly change the generation profile of the NEM in the upcoming years, leading to more renewables connecting to the network. Much of the renewable resources are located in remote areas, which presents a challenge to the current network connection arrangements.

The ERAA therefore considers it important from a whole of market perspective that the AEMC investigate options to address the weaknesses in the current connection regime.

Preferred mechanism to be further developed

In regard to the options presented in the Interim Report we consider that further development of Option 2 would be appropriate. Option 1 whilst addressing the coordination problems that Transmission Network Service Providers currently face when connecting new generators, does not tackle the inherent market failure in the current arrangements. Specifically the impediments to achieving economies of scale in remote connections associated with the ‘first mover’ problem where individual parties are discouraged from investing in transmission infrastructure due to high upfront costs and the risk of stranding.

Given that Option 2 calls for the socialising part of the upfront cost of transmission infrastructure, it is important that clear and efficient rules are developed in defining the economic test that Network Extensions for Remote Generators (NERGs) would have to satisfy. It will be important that the National Transmission Planner (NTP) does not attempt to arbitrarily pick winners amongst different classes of renewables. Development of clear rules around issues such as the weighting given to renewables that are capable of providing baseload generation as opposed to those that are intermittent, as well as other assessment criteria will be required.

Augmenting networks and managing congestion

Congestion impacts retailers via reduced competition in the contract market

From a retailer perspective congestion is relevant to the extent that it affects the cost structure of generators and their consequent contracting behaviour. If congestion increases in significance it could over time reduce the liquidity of the contract market, and thereby reduce competition.

Now is the time to address congestion

In this context, it is important that the AEMC adopt a forward looking approach in regard to congestion, in much the same way as the proposed approach in dealing with any prospective significant shortfall in generation. This would require the AEMC being proactive in developing mechanisms to deal with any future congestion, rather than waiting for the problem to manifest itself.

The key message from the Congestion Management Review was to delay action on congestion in the NEM until the details surrounding the climate change policies were known and their impact on the network ascertained. Now that much of the CPRS and RET design elements have been (or are soon to be) finalised it is now time to consider how congestion can best be dealt with. It should be noted that there is already evidence of increasing levels of congestion in some areas of the NEM (e.g. South Australia) due to a large concentration of wind farms.

Addressing congestion within existing market framework

The ERAA considers that one of the keys in addressing congestion is the provision of appropriate locational signals to generators. This could involve the imposition of a penalty on generators who chose to locate in areas that are deemed to already be congested.

The current Rules (5.3 to 5.4A), at least in theory, allow generators to lock in a level of access at the time of their connection (or get compensation if they are constrained). At the time the market commenced this was identified as a key part of both the open access regime and the method by which the network would be augmented and extended. Despite these Rules, the ERAA is not aware of any instances of an NSP having implemented such an arrangement, mainly due to their concern that they will be unable to negotiate the appropriate TUOS or compensation charge with later entrants.

It is important that the AEMC investigate how best to operationalise (if possible) these Rules in the current market environment. This approach is consistent with option 2 for extending the network since it requires the newly connecting parties to pay for their own access, including the relevant extension of the shared network. Obviously, extending the network without preventing congestion inside the existing shared network is pointless.

The AEMC should therefore define the normal augmentation Rules based on the current approach where incumbent generators access is protected (or compensated) using Rules 5.3 to 5.4A. Option 2 could then be an add-on for

limited circumstances, mediated by the NTP, where a larger number of generators are expected to connect than can reasonably be handled by the steady state process.

Inter regional transmission charging should be addressed

Augmentations to the inter-regional transmission network may also prove necessary if the policy outcomes of the CPRS and RET are to be achieved. The AEMC outlined four preliminary options for an inter-regional transmission charging mechanism (IRTCM) in its NTP Report, which were to be progressed further under this Review. These options were not explored in detail in the Scoping Paper or Interim report. The ERAA views the further development of the IRTCM is an important part of managing congestion in the market.

Retailing

Retail price regulation the priority issue in this review

As noted elsewhere in this submission, the ERAA considers the continuing regulation of retail prices following the introduction of the CPRS as one of the most significant risks to the investment environment. The ERAA strongly agrees that the current regulated retail price arrangement will prove inadequate in dealing with the changing cost environment under the CPRS. The AEMC has specifically recognised the nexus between the financial security of retailers and the ongoing investment in new generation and infrastructure. The successful transition to a carbon constrained economy will be reliant on ensuring continued confidence in the investment environment, and the ERAA would therefore encourage the AEMC to continue to give this issue priority in considering the appropriate regulatory response to the introduction of the CPRS and expanded MRET.

Impact of retail price regulation on the energy sector investment environment

The existing retail tariff regimes already give rises to significant risk to retailers, as there are inherent complexities involved in trying to estimate future costs in an environment of imperfect information. These difficulties will be exacerbated under the CPRS. The introduction of a CPRS will signal a complete 'step change' in the energy market cost structure, and its impact on contract prices and liquidity is unknown. Further, the ability to accurately forecast future carbon prices will be very constrained, particularly in the early years. The likelihood that the current mechanisms and methodologies used to determine regulated retail prices will accurately capture these costs is extremely low.

The impact of the CPRS on a retailer's costs will be significant, and any constraint on the ability of a retailer to recover these costs presents very real risks to ongoing retailer viability. If the regulatory regimes are not sufficiently flexible, retailers are effectively being required to sustain ongoing losses for defined 'price

path' periods. Such an outcome presents an obvious threat to market sustainability, stability and confidence.

De-regulation of retail prices is the optimal policy option

The optimal solution to these problems is retail price deregulation, which would provide retailers with the latitude to adjust prices in response to a dynamic cost environment. Competition in the retail marketplace would create strong constraints on the ability to pass through inappropriate cost increases, while allowing genuine industry wide cost structure adjustments to flow though in a competitively neutral manner. The experience in Victoria has shown that deregulation can be introduced without disruption to the marketplace.

Preferred approach if de-regulation is delayed

Despite deregulation being the most efficient and effective mechanism to deal with the inefficiencies and investment distortions identified above, the ERAA does recognise that this is unlikely to occur in all NEM jurisdictions before the start of the CPRS. The AEMC has not yet completed its review of the effectiveness of retail competition across jurisdictions, and where these reviews are completed (e.g. South Australia) there may be a time lag before a decision to deregulate is made by State Governments.

Despite this potential for delay, the ERAA is encouraged by the MCE's commitment to the principle that regulated tariffs should allow full pass through of carbon costs. While this is a positive principle, we are mindful that the details surrounding how this will be achieved have not yet been decided.

In further pursuing this matter, the ERAA encourages the AEMC to conduct extensive consultation with retailers and jurisdictional regulators with a view to establishing a robust approach to establishing regulated retail prices in the context of the CPRS and RET.

The purpose of this consultation should be to develop a;

- Set of principles to guide the development of approaches and methodologies which can be adopted to ensure that regulated tariffs capture the full cost of carbon and the RET; and
- Commitment to introducing a greater degree of flexibility in price path arrangements. For example, consideration should be given to price adjustment provisions, whereby regulated retail prices would be 'adjusted ex-post' to ensure full cost pass-through is used in the tariff calculation.

Resolution to cost pass through has become urgent given the timing of cost increases

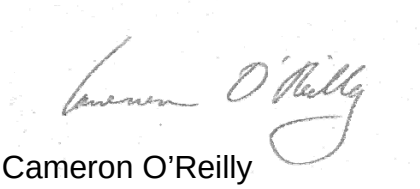
We note that the CPRS is to be implemented in 2010, and that the expanded RET will begin to create significant costs in a similar timeframe. In this context the

need to implement appropriate clarity around how costs will be passed into regulated tariffs if the investment environment is not be damaged.

The ERAA would be pleased to participate in further discussions with the Commission on the views expressed in this submission, or matters associated with the impact of climate change policies on the retail market more generally.

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

Yours sincerely



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