Energy Supply Association of Australia www.esaa.com.au

ABN 98 052 416 083

Level 14
50 Market St
Melbourne

GPO Box 1823
Melbourne
Victoria 3001

P +61 3 **9205 3100**
E info@esaa.com.au

16 December 2015

Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235
Email: submissions@aemc.gov.au

National Electricity Amendment (Demand Response Mechanism and Ancillary Services Unbundling) Rule 2016

The Energy Supply Association of Australia (esaa) and the Energy Retailers Association of Australia (ERAA) (the Associations) welcome the opportunity to comment on the AEMC's Consultation paper on the rule change proposal *National Electricity Amendment (Demand Response Mechanism and Ancillary Services Unbundling) Rule 2016*.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 34 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 59,000 people and contribute $24.1 billion directly to the nation's Gross Domestic Product.

The ERAA represents the organisations providing electricity and gas to over 10 million Australian households and businesses. Our member organisations are mostly privately owned, vary in size and operate in all areas within the National Electricity Market (NEM) and are the first point of contact for end use customers of both electricity and gas.

The esaa's policy position is that demand management should be facilitated via open and competitive markets. Further, the esaa is supportive of improved market signals however, we do not believe that a robust case has been put forward to demonstrate that the current market settings are failing to deliver an efficient demand response or that the identified costs and benefits of this proposal are sufficiently reliable to justify the proposed rule change.

The Associations and the National Generators Forum have made a number of submissions on this topic over the past decade including engaging numerous consultants (Seed, SFS Economics) to prepare analysis of the issue. This submission is in addition to these earlier papers which are available to the AEMC.

What is Demand Response?

Demand Response (DR) refers to actions that can be taken by electricity customers to reduce load in response to certain market or system conditions. DR is triggered in response to price signals requires the customer to curtail their consumption, which entails a (potentially very significant) opportunity cost. Customers contemplating an economic DR

therefore face a trade-off, in terms of any bill savings they can achieve versus the direct and opportunity cost associated with curtailing their consumption

The esaa notes that there are existing commercial arrangements between retailers and their customers in the National Electricity Market (NEM) that already facilitate a demand side response. These include arrangements such as interruptible contracts, scheduled and unscheduled demand response, and spot price pass-through. Some retailers also engage third-party specialists to assist in the delivery of this service.

The lack of regulated disclosure of demand side response does not mean it does not exist.

Is there a problem for Demand Response?

Not only does the proposed change fail to improve the function of the market, the esaa does not believe that there is a clear articulation of the market failure that the proposed rule change is trying to solve. The COAG Energy Council appears to support a general desire for more DR.

If the question is appropriately framed as "what, if any, are the barriers to the provision of efficient DR?", then the only way to demonstrate any incremental gains from introducing the DRM is:

- outlining what the barriers are, if any;
- establishing how these barriers are stopping the provision of DR to an efficient level; and
- demonstrating how the DRM will address any identified barriers.

As there are ways to offer DR in the current market, and some businesses already do, the onus on the rule change proponents is to demonstrate that there are nevertheless material barriers to its uptake. As long as some retailers are engaging in DR arrangements with their customers, it is not relevant that others may not be, as this is only evidence of the diversity of service offerings expected in a competitive market. Indeed, such a situation is explicitly endorsed by the rule change proposal. Further, it is not clear that the current bundling of DR with a retail contract is a material problem worth regulating, any more than unbundling network services, reactive power management or white/green certificate procurement.

Given this, the esaa does not understand how the regulating of an unregulated activity, absent a market failure, can result in an increase in that activity. The only way that the optional regulation, in this case DRM, can increase that activity is to create an explicit or implicit subsidy to those regulated (otherwise the supplier would not choose to be regulated). The esaa note that the Brattle Group report provided with the rule change proposal indicates that in the Singapore energy only market this incentive is to be funded through a levy on consumers (via retailers). In terms of the National Electricity Objective, the subsidy is a transfer of wealth arising from an inefficient level of activity caused by regulation. This is unlikely to improve economic efficiency.

As the premise is a subjective assessment, without evidence, that there has been too little DR in the NEM, the DRM has been proposed as the solution. While DR and total consumption cannot be considered equivalent, it is important to note that AEMO has found that demand for electricity in the NEM has fallen by approximately 1.8 per cent year on year since 2009. This fall in demand has been widely attributed to decreased manufacturing

activity, increased energy efficiency as well as significant investment in solar PV. Improvements in energy efficiency and investment in solar PV can reasonably be considered a form of DR, as end use customers are responding to price signals, albeit these signals have been inefficient due to poor network pricing and subsidies.

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In considering the merits of DR, some of the benefits can be overstated. For example:

Lower prices do not in themselves constitute an economic benefit to society, where they simply represent a transfer from producers to consumers. This is a key distinction that is also reflected in the Regulatory Investment Test for Transmission (RIT-T). In any case, the effect of DR will not be to reduce wholesale and retail prices. In a dynamic market setting, prices will adjust to account for the changed market risks associated with transfer payments to customers participating in DR.

- Specifically in the context of an energy-only market like the NEM, a policy designed to suppress prices and reduce infra-marginal rents to generators is not consistent with dynamic efficiency objectives.

- If the DRM increases participation of unscheduled demand response, there will be adverse consequences to the efficiency of central dispatch as scheduled generators face increasingly non-transparent market conditions in which they try to optimise their dispatch.

These factors were taken into account in the Oakley Greenwood (December 2014) cost-benefit analysis of the DRM, which found the (original) DRM design to be net cost under all feasible scenarios.

The Proposed Rule Change

The rule change proposal is to implement DR in the energy market that allows demand reductions to be rewarded via the wholesale spot market without actually requiring customers providing the demand response to become market participants. Further, AEMO would play a key role in developing and managing the methodologies used to calculate demand reductions.

Three proposed barriers to competition are put forward in the Consultation Paper (Page 10).

1. Existing DR options imply incurring costs to monitor and manage exposure to wholesale spot price risk. The Energy Council identifies these costs as being greater than the potential benefits of being exposed to the wholesale spot price risk resulting in customers' not choosing these options.

2. Retailers have an incentive to limit demand response because it reduces the wholesale spot price risk they manage on behalf of their customers for which they get a reward in the retail market. So, unless demand response delivers a greater reward than selling energy, the retailer will not be active in this area.

3. Large users have also reported that the terms offered on demand response contracts are generally not attractive.

These three points do not indicate that there is a problem in the NEM that requires intervention, rather it highlights the effectiveness of the competitive market. Points one and three above indicate that the costs of offering DR exceed the benefits in a competitive market. Moreover, in a wholesale market experiencing low prices there is little if any incentive to offset demand. Point two highlights the risk management role of retailers, however rather than ignoring a cost effective way of hedging load, retailers are likely to integrate DR into their hedge book, including all manner of derivatives, different generation types and DR. It also assumes, without supporting evidence, that retailers' profit margins are directly linked to the level of risk mitigation they provide to their customers. To the extent that risk mitigation is achieved by the retailer taking on more risk itself, then it is logical that the rewards rise with the risk. Conversely, if the retailer has tools to reduce risks- such as via DR, it will be willing to accept a lower return, which in turn improves the competitiveness of its offerings versus a retailer that does not engage in DR.

The DR approach, as proposed, would impose additional costs. The ongoing total cost of the repeated calculations of baselines and calculation of modified settlements associated with demand response intervals will be greater than the current costs for settling the NEM. These additional costs will be required to calculate initial baselines regardless of whether demand response events occur. These additional costs should not be imposed on the NEM participants. AEMO should separately calculate these costs and the costs should be paid for by DR agents (DRAs). As this service is being created to facilitate entry of DRAs into the NEM, DRAs should be required to pay a fixed weekly fee for the service in addition to the fees as set out in Table 5.3 of the Commission's consultation paper.

The DR rule change does not allow for the DR to be scheduled and set price. This is not what the AEMC originally intended in the Power of Choice review and would result in inefficient pricing. This is because the marginal cost of the DR service will not be reflected in pool prices. This is essentially the problem with non-scheduled load, as it leads to mispricing with allocative and dynamic inefficiencies. Since the Power of Choice review the volume of DR activity may have changed and there is clear indications that technological advancements have impacted on the market.

This leads on to the question that if the intent was for DR to be scheduled, then why are the aggregated services of DR not scheduled in the proposal? If the answer is that DR can't be scheduled, then this suggests the providers don't have a firm service and therefore should not be paid as though they are able to provide the service. For this reason (if the rule were to be brought into effect) it may be sensible to investigate options to make the DR 'firmer' and to prevent abuse of the baseline. It is sensible to have some form of penalty rate if the DR/DRA does not meet the contracted reduction. This may be similar to the arrangements in Singapore and could improve the quality of DR. This proposal may reduce the uptake to DR, however if uptake is solely premised on a 'regulated in' wealth transfer, then logic would suggest the rule change proposal will not benefit consumers and should not be made.

Finally, rather than reducing regulation within the industry the proposed DR is likely to increase regulatory costs and risks for market participants The DR would impose significant implementation costs and distort the contracts market. All evidence in the past discussions on the costs and benefits of DR, under various different models, is that it does create a benefit for a small number of very large electricity users that is more than offset by the costs imposed on all electricity consumers.

If you have any questions, please contact the esaa on (03) 9205 3100 or the ERAA on (02) 8241 1800 and we will be happy to facilitate such discussions with our member companies.

Yours sincerely

Tim Reardon
General Manager, Advocacy
esaa

Alex Fraser
Interim CEO
Energy Retailers Association of Australia