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Power of Choice Draft Report

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Australian Energy Market Commission's (AEMC) Power of Choice Draft Report.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 51,000 people and contribute $16.5 billion directly to the nation's Gross Domestic Product.

The esaa has been actively involved in the AEMC's reviews into demand side participation (DSP) in the National Electricity Market (NEM). DSP is crucial to containing retail price rises by empowering consumers to use energy in an efficient and cost-effective way.

A wide variety of issues that have a range of effects on electricity generators, network businesses and retailers are considered in the draft report. This submission discusses three of the issues that the esaa considers are of most importance to the industry as a whole. in particular, the role of the proposed demand response mechanism. The esaa, in conjunction with the National Generators Forum, commissioned research from SFS Economics to examine the impact of the proposed mechanism. This report is at Attachment A. We also provide our views on other topics raised in the AEMC's draft report.

Flexible pricing

The esaa has long argued for the introduction of flexible pricing to enable the cost of supply to be more accurately reflected. Tariffs that signal when demand is highest - and thus electricity is costliest to supply - are needed to help encourage more efficient use of electricity. However, if state governments decide to shield consumers from this, reductions in peak demand may not occur, as consumers will be unable to access the benefits of their own peak demand reduction and accordingly have limited incentive to make reductions.

While the AEMC's proposals are welcome, they will only provide a genuine benefit if state governments are prepared to allow the electricity market to implement flexible pricing.

We therefore broadly welcome the AEMC's proposal to introduce time varying network pricing. However, the detail of such arrangements will of course be essential to understand the full impact on the electricity market.

The proposal to introduce three bands for small business and residential customers is an interesting concept. However, we do note that there will be issues regarding the levels of the thresholds and what happens if a customer's use varies between one band and another. Rather than specifying three bands, there could be merit in analysing the costs and benefits of a range of scenarios in terms of number of bands and the thresholds.

We consider that there are real advantages in giving consumers the opportunity to trial flexible pricing on a 'no regrets' basis. On 26 September 2012, the Victorian Government announced that it would allow consumers to switch to and from time of use (TOU) pricing tariffs without penalty for a limited period. The Association considers that such an approach is an appropriate way to introduce people to flexible prices.

However, we are concerned by the Brattle Group's proposed approach to provide temporary bill protection. The Brattle Group suggests that this approach would mean that "a consumer's bill on a time varying tariff could be no higher than it would have been otherwise under the applicable tariff". This amounts to imposing an effective bill 'cap'. This goes against the move towards market-driven prices. Giving consumers the option to trial flexible prices is a more effective way of empowering them to switch to flexible pricing if they wish. It is also unclear how any difference between flat rate and flexibly priced bills would be funded. Accordingly, while energy retailers may wish to offer such a service in the early stages of a move to flexible pricing, they will only do so if they can make a financial case for doing so. They should not be required to do so, when they may be left out of pocket.

Proposed demand response mechanism

The AEMC's proposal to introduce a demand response mechanism (DRM) that pays end users via the wholesale electricity market for reducing their demand raises serious concerns for the industry. The proposed model would pay consumers the prevailing spot price if they reduce their consumption below a baseline level.

The esaa has commissioned research on the proposed DRM to investigate its economic impacts. The report finds that there are potentially significant economic costs associated with the DRM and that the supposed benefits of the mechanism are questionable. The report from SFS Economics is contained at Attachment A.

The industry considers that there are several issues related to this proposal which have not been adequately addressed in AEMC's draft report. Firstly, it is unclear why this specific mechanism is needed. Large consumers can already enter into agreements with their energy retailer to take on greater exposure to the spot price.

By reducing consumption at times of high prices consumers would benefit through lower energy costs.

The proposed DRM offers low risks for the consumer but increases the risk for both energy generators and retailers. This is due to the role of hedging in the energy market. SFS Economics' report explains that "the DRM introduces a disconnect between the demand that must be hedged by retailers in the contract market (as reflected in the baselines of DR customers), and actual (metered) demand and therefore actual generation in the spot market. In the short run, generators contracted to meet baseline demand will therefore be exposed to greater financial risks from unfunded difference payments." As financial markets respond quickly to changes in risk, prices of hedge contracts will rise to adjust to this and this will consequently be passed on to all consumers. Essentially, this proposal places the risks on energy retailers and generators while allocating the rewards to individual consumers.

Additionally, the purported industry savings from the proposed DRM are poorly targeted. Most savings achieved through such a measure would come through reduced network costs as infrastructure upgrades could be delayed or deferred. However, there is no link in the proposed mechanism to electricity networks. The AEMC appears not to have considered that high price events in the wholesale market do not necessarily correlate with peak periods in network areas.

Finally, the proposition of establishing baselines is complex and could be subject to gaming. In some instances, a business with a back-up generator could elect to use this in order to generate electricity rather than purchase it from the grid. This would then appear as if the business' consumption had fallen below the baseline, while in fact, consumption remained the same. This has been the source of much of the demand response in some similar demand response schemes in the US.

The value of such a demand side response is already being considered by the AEMC in its Small Generator Aggregator Framework rule change. The Association considers that this is the appropriate mechanism to deal with such a demand side response, rather than potentially allowing this to occur through the Power of Choice's proposed demand side response mechanism.

Metering Arrangements

While the issue was raised in the AEMC's Draft Advice on market arrangements for electric vehicles (EVs), the proposal to allow consumers to engage multiple Financially Responsible Market Participants (FRMP) at one connection point relates equally to the Power of Choice review. As the esaa raised in its submission on arrangements for EVs, we are very concerned with this proposal. In particular, the prospect of allowing one FRMP to disconnect the entire load including the load of other FRMPs at one connection point.

Electricity is considered an essential service, and as such there is a robust set of arrangements in place to ensure that disconnection only occurs as a last resort. This, along with financial penalties for wrongful disconnection, aims to ensure that disconnection can only occur after a process which is designed to retain, where possible, a viable connection. Many energy retailers do more than they are obligated to do in order to maintain a customer's connection.

In the event that multiple FRMPs were able to provide multiple connections to a customer, a number of anomalies arise. First, some particular restrictions on disconnection may only apply to one FRMP rather than all. In cases such as these, a situation could arise where one FRMP was able to disconnect the customer while another was not. It appears that the AEMC has not considered the complexities of such arrangements.

Second, AEMC's proposal for multiple FRMPs at one connection point raises the questions of what the essential service component of electricity is. This proposal raises the prospect that failure to pay for a service such as an EV or possibly an air-conditioner could lead to the disconnection of an essential service.

It is possible for metering to be arranged so the different loads can be separated and disconnected separately if required. This would be a preferable situation to one where the entire load can be disconnected by a third party FRMP. However, making these metering arrangements available has a cost. The Association considers that the end user or third party needs to be responsible for the cost of making this metering available. However, we have other concerns with this proposal.

Even if both FRMPs were subject to the National Energy Customer Framework (NECF), there is no rationale to grant both entities the same rights to disconnect a household. The esaa considers that the best way to ensure customer protection and avoid wrongful disconnections is to ensure that only one FRMP – the one with primary responsibility for supply – has the right to disconnect a single connection point.

There is also a range of incremental system costs associated with allowing for multiple FRMPs at the one connection point. This could be acceptable where the benefits of such arrangements outweigh the costs. However, if the benefits accrue to a third party while the costs are borne by the retailer or network service provider then there is a mismatch in the design of the system. As the AEMC's draft advice stands, the proposals for parent/child metering and multiple FRMPs would lead to costs for retailers, while the benefits would fall to EV charging companies or similar entities.

The Association contends that the AEMC should use a cost-benefit analysis of having multiple FRMPs at one connection point in order to better understand the cost impacts associated. Currently, it is unclear how the costs will be spread across energy businesses and consumers, and whether there will be any broader benefits to the market.

The esaa does not oppose third parties entering the retail energy market space per se. Competition, where it has been allowed to flourish, is the best way to keep energy prices at an efficient, cost-reflective level. However, the policy settings need to be correct in order to avoid unnecessary costs and complexity. At the first instance, there is the question of which types of services could be eligible to be spun-off to a third party. EV charging seems to be the most obvious case; bundled services for heating and cooling, hot water or pool pumps may also arise. If these bundled services are not classified as energy supply, but rather an energy service that is accordingly subject to a different form of regulation and cost, and are not

appropriately managed then there is a range of consequences for the supply of electricity.

One of the key issues with splitting supply at a connection point will be how costs are shared amongst the FRMPs. For instance, how will network charges such as the daily supply charge for a connection point be split? If the original or 'primary' retailer is left to charge (and recoup) this cost alone, then its service will appear to be more expensive compared to a third party which does not have to pay for this. Additionally, retailers are responsible for a variety of other costs such as compliance with the Renewable Energy Target (both the small-scale and large-scale schemes), state government energy efficiency schemes and feed-in tariffs for solar PV.

There is no clear direction from the AEMC as to how these costs might be shared among participants. If third parties are exempt from these liabilities then once again, the retailers' costs will be higher (due specifically to distorting policy settings) compared to a provider without these obligations. In such a situation, third party providers would therefore have a distinct advantage, and the incentive would be for consumers to split their load in as many ways possible. Consumers who do not respond will end up bearing a disproportionate share of such costs, which may raise issues of equity.

This also raises the possibility of whether existing retailers would be able to split their supply to compete in this new market. If there are barriers to existing retailers creating subsidiaries to enter this market then they will possibly face higher costs which will be passed on to all consumers, including those unable to engage with the new 'bundled services' market.

The Association is concerned that the AEMC's proposals for multiple FRMPs will create a system which provides rights to parties without requiring them to have any of the responsibilities that existing energy supply businesses face and an inappropriate division of system costs.

Other issues

The Power of Choice draft report makes a range of other recommendations which are of interest to the esaa. Firstly, the Association is interested in the recommendation to require AEMO to publish market information on representative consumer sector load profiles. We agree with the AEMC that broader market information can assist parties to develop products and services and improve the efficiency of the energy services they offer to consumers.

We also consider ensuring consumer protection is a vital part of determining whether elements of the NECF apply to third parties engages in providing DSP services. Governments, energy businesses and other stakeholders have invested considerable effort in negotiating the NECF to find a common set of customer protections for energy users. It is therefore strange to see the AEMC being so willing to create new types of market participants who will offer energy services to customers without being bound by these protections. A level playing field for businesses engaged in the energy market, be it as a retailer or a third party, is crucial.

Finally, the esaa contends that the AEMC's recommendation to ensure minimum functionality for new meters installed for residential and small business customers is a positive step. Improving existing metering technology should help to enhance the information that the energy industry has on how consumers use their energy. This should help to develop new services and improve planning which will have benefits for the industry as a whole.

Conclusion

DSP will be an important feature in the energy market over the coming years. Ensuring that the market settings are right will help to secure the best outcome for consumers and industry alike. While the AEMC's draft report on DSP in the NEM contains several positive recommendations, the industry is concerned by other aspects of the report, in particular, the proposed demand response mechanism for wholesale markets. The esaa considers that there are a range of problems with the mechanism as it is proposed which could produce perverse outcomes. A consultant's report at Appendix A outlines the industry's concerns in greater detail.

The prospect of multiple FRMPs having the power to disconnect a customer's entire load is also concerning to the Association. As electricity is an essential service, we maintain that ensuring only the primary supplier of electricity has the power to disconnect a load ensures that consumers are better protected than under the proposed multiple FRMP model.

Any questions about our submission should be addressed to Kieran Donoghue, by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9205 3116.

Yours sincerely

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