



Major Energy Users Inc.

Australian Energy Markets Commission

**National Electricity Amendment (Scale Efficient
Network Extensions) Rule 2011**

Comments on the new Draft Rule

Submission by

The Major Energy Users Inc

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Executive Summary

The Major Energy Users Inc (MEU) has been a consistent opponent of the proposed Scale Efficient Network extensions (SENE) rule change from the time it was first developed during the AEMC review of the impact of climate change policies on energy markets frameworks.

The main reasons for the opposition to the initially proposed rule have been that:

- It had not been demonstrated that the initial draft rule would lead to lower costs for consumers
- Consumers were required to assume a risk that they were unable to manage
- It reduced generator locational signals
- Generator competitive neutrality was compromised
- It moved away from the underlying principle of “causer” pays
- The proposed rule would significantly increase complexity and create unnecessary distortions in the market

The MEU was of the view that the existing rules already adequately provided for the development of “multi-user” network extensions and therefore the additional risks that consumers were required to assume associated with the implementation of the initial draft SENE rule change could be readily avoided and was therefore unnecessary.

The AEMC posited at the recent SENE public forum that there always remained “Option 6”, which was to maintain the status quo. The revised rule effectively reverts to option 6 – retaining the status quo, albeit with a requirement that additional information be provided to the market.

The MEU considers that the latest AEMC assessment (which underpins the revised rule change proposal) provides a strong and cogent argument in favour of retaining the “status quo”, although the revised rule does provide some clarity for generators seeking “multi-user” network extensions and provides an ability by network service providers to provide for these extensions to meet the needs of generators.

The new draft rule is **fully supported** by the MEU and reflects the approaches and concepts the MEU initially proposed in its response to the second interim report by the AEMC in relation to its review of the Energy Market Frameworks in light of Climate Change Policies, and in responses to the initial draft SENE rule and the subsequent options paper.

1. Introduction

1.1 About the MEU

The Major Energy Users Inc (MEU) represents some 20 large energy using companies across the NEM and in Western Australia and the Northern Territory. Member companies are drawn from the following industries:

- Iron and steel
- Cement
- Paper, pulp and cardboard
- Aluminium
- Processed minerals
- Fertilizers and mining explosives
- Tourism accommodation
- Mining

MEU members have a major presence in regional centres throughout Australia, e.g. Western Sydney, Newcastle, Gladstone, Port Kembla, Albury, Mount Gambier, Whyalla, Westernport, Geelong, Launceston, Port Pirie, Kwinana and Darwin.

The articles of the MEU require it to focus on the cost, quality, reliability and sustainability of energy supplies that are essential for the continuing operations of the members who have invested \$ billions to establish and maintain their facilities.

1.2 The MEU view on “scale efficient network extensions”

In its earlier response to the rule change initially proposed by the MCE to implement scale efficient network extensions (SENEs) the MEU observed that:

- There was little doubt that, all other things being equal, providing a single large network element is more efficient than duplicating multiple network assets to provide the same service to a number of separate (and small) generators
- Other than a conceptual view that with efficient connections, consumers might receive a benefit, the AEMC had not demonstrated that the benefit to consumers of a SENE will be greater than the consumer’s share of the costs and risks
- The signals for efficient location of generators were already muted and the introduction of SENEs as proposed would mute these further
- The introduction of SENEs would result in a number of other negative aspects in relation to the market as a whole:

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- Competitive neutrality between generators would be undermined in that some generators will get a SENE benefit but others would not if there was no SENE nearby for them to utilise
- All generation types would benefit, not just the targeted renewables projects which was the underlying reason for the rule change proposal in the first place
- There would need to be some definition as to when generation is too small (where any connection is, therefore, inefficient) or too large (generation is able to support its own connection on its own commercial criteria)
- There were significant complexities introduced in layout, the degree of firmness of access and charging generators for the connection provided
- It was not efficient to impose on consumers risks and costs that they are not able to manage and that it was more efficient for those able to manage the risks, to be required to manage them

1.3 Summary

The MEU considered consumers would face increased costs and risks under the initial draft SENE rule, but would have no ability to either manage the increased risks or see an offsetting benefit to the increased costs.

The MEU saw the SENE approach as changing the dynamics of generation investment, as it effectively introduced the concept of “picking winners” and allowing those “winners” to minimise their risk and costs by having consumers underwrite these.

As an overarching observation, the MEU considered the dictum that “if it ain’t broke, don’t fix it” had particular relevance to the AEMC earlier approaches to the initial draft SENE rule change.

2. Was a consumer underwritten SENE ever a better approach?

The entire SENE approach was based on the concept that with the introduction of a large number of small renewable generators as a result of the decision to mandate 20% of generation to be provided by renewable sources, there would be a need for additional network extensions. It was considered that as many of these renewable generators would be located in similar regions which might be remote from the existing shared networks and, consequently, the cost of these renewable generators to connect would be prohibitive.

What had been overlooked in the analysis was that significant renewable generation had already been provided under the current rules and there were significant amounts of new renewable generation being planned to meet the increasing amount of renewable generation needed. What was also overlooked was that there were incentives already in place to allow renewable generation to be provided and that SENE would unnecessarily add to these incentives.

The MEU had always considered that the current rules adequately allowed for prospective generators to negotiate with an NSP (and not just the incumbent NSP) to jointly develop a SENE. Being a new connection (and therefore not controlled by the rules which limits the return an NSP gets for its shared network) a new connection allows an NSP to accept increased risk for an increased reward. This means that an NSP can, if it wishes, undertake an extension which is oversized with an expectation that more generators might connect to the extension rather than build a new dedicated connection.

It is important to recognise that the current rules are quite flexible in allowing any network extension (accepting that it applied at the point of connection to the shared network) to be constructed by any qualified party, whereas the initial SENE concept effectively proscribed such extension to be only built by an incumbent NSP.

In its draft determination, the AEMC addressed three aspects specifically and assessed the initial draft rule in relation to each:

- Efficient allocation of stranded asset risk
- Market based vs central planning approaches
- Complexity of the outcomes

2.1 Efficient allocation of stranded asset risk

The AEMC notes that providing spare capacity for generation has a high risk compared to building spare capacity for load. This is because a generator might not ultimately connect at all, and if it does, it might well locate elsewhere. In contrast, load tends to grow consistently and usually where there are existing resources.

With this in mind, the AEMC quite rightly identifies that the decisions for generator location lie exclusively with the generator and it is not within the purview of consumers to influence the generator locational decision. The AEMC points out that the most efficient option for any decision comes from a party most able to manage the decision – it does not necessarily result where a party is able to transfer the risk to someone else.

If consumers are required to assume the risks for underutilised asset capacity, then this will take away from the parties most able to manage the risk, the responsibility for managing it, with the result that the lowest possible cost will not be achieved.

The initially proposed rule had AEMO and AER having involvement in which SENEs would proceed. Having AEMO and AER involvement was seen as providing adequate protections to ensure inappropriate investments were made and yet neither have all of the information necessary for making a well informed decision.

In this regard the AEMC has now identified that the most efficient decision making will be undertaken by the party best able to manage the risk and where the risk is borne by the entity making the investment decision. The MEU concurs with the AEMC in this analysis. Once this is recognised it becomes much clearer as to where the risk for the asset stranding should lie.

As the decision involving the extension of the network to connect new generation lies with the generator and the party which will build the extension makes the decision to size the connection, it follows that they are the parties best able to manage the risk of asset stranding.

That there is a risk of asset stranding it therefore follows that the party bearing the greatest risk for the connection asset is the connection asset owner, then the connection asset owner should be able to secure a higher return for that asset than it would for assets where there is little risk of asset stranding. The current Electricity Rules allow for the connection asset owner and the party connecting to the shared network to negotiate an outcome which reasonably reflects the risks to each party to the negotiation.

Under the initial draft rule, consumers would bear this risk even though they were totally unable to manage the risks involved. The new draft rule sensibly leaves the management of the connection risk with the two parties who are intimately involved with initiating the connection and owning the connection asset.

There is a view that the beneficiary of the lower connection cost should bear the risk of asset stranding. In this regard, it is clear that the initial beneficiary of the lower cost connection is the generator that is connecting. This lower cost would result in the new generator having a lower cost for its output and therefore it will

more likely be dispatched ahead of higher cost generation. The assumption is then made that the benefits from the lower cost generation will be passed to consumers, who become the eventual beneficiaries. As the AEMC rightly comments, there is no certainty that consumers will benefit from lower costs as this would require the new generator to pass the savings on. Equally, the new generator could retain the savings and so enhance its profit.

Either way, there is no certainty of where the lower cost of the connection will be taken, or indeed if the increased efficiency exceeds the cost of asset stranding. In all probability, any benefit will ultimately most likely be shared in some way between the new generator and consumers but in an unknown proportion. Because of this the AEMC rightly concluded that there is no way of quantifying any benefit that may or may not flow to consumers, and so for consumers to bear the risk of asset stranding is entirely inappropriate.

The MEU totally supports the AEMC analysis of this risk management approach and its conclusions.

2.2 Market based vs central planning approaches

Generally, it is accepted that a market based approach is preferable to a centrally planned approach. This basic premise underpins the entire reason for disaggregation of the electricity market in the first place, as Hilmer had identified that centrally planned and managed systems (such as electricity supplies) were inherently less efficient than market based systems.

There is no doubt that the initial draft rule for SENE and the options proposed by the AEMC, comprise a significant element of central planning and deliberately moved away from an approach whereby the market decides what is the most efficient approach. The MEU considers that there needs to be very powerful reasons to move from a market approach to a centrally planned approach. As there is no clear efficiency gain from making such a decision in regard to SENE (other than an intuitive assessment), the clear indication is that there should not be such a change made.

The new draft rule notes that instead of active intervention, there should be increased information made available so that better decision making can be made.

The MEU agrees with the AEMC that better provision of information can only increase the efficiency of decision making by the parties directly involved. The MEU also agrees with the AEMC that a market based outcome is preferable to a centrally planned or regulated one.

The MEU supports the AEMC analysis and conclusions surrounding its decision to prefer a market based approach but requiring increased availability of information so that better decisions can be made.

2.3 Complexity

The AEMC notes that changes to the Rules should be appropriate and proportionate. The outcome of this is that any increase in complexity should be associated with significant benefits to the market operation and outcomes – such an approach reduces regulatory uncertainty.

There is little doubt that the initial draft rule increased complexity as did, to varying extents, the five options examined by the AEMC. The initial draft SENE rule would have moved away from a mechanism that was working adequately to one that provided some benefits to some new generators but not to all. It also had the detriment of requiring involvement of AEMO and the AER and a transfer of risk from proponents to consumers with associated increased costs for consumers.

The current arrangements for negotiating new connections resulted from extensive debate when the transmission rules were developed in 2005 and 2006. Since that time they have resulted in a number of network extensions being negotiated and built.

There is little doubt that the initial arrangements would have increased the complexity of managing the issue of making new generator connections. In contrast, the new draft rule requires the provision of additional information which will have the effect of reducing the complexity of making new generator connections by the provision of data aimed at making decision making by new generators more easily carried out.

This provision of additional data is not costless and this cost will be a burden on consumers who provide the bulk of the revenue to NSPs. However, this cost is likely to be very small in contrast to the cost associated with the initial draft rule and the other options considered.

The MEU agrees with the AEMC that the new draft rule provides some change to the existing rules, but with little change to the way the electricity market is currently managed.

The MEU supports the AEMC analysis and conclusions in regard to the issue of the complexity that the initial draft rule would have caused and the decision to essentially maintain the current approach to new generator connections, albeit with a requirement for the provision of additional information.

2.4 Summary

The MEU saw that there were major negatives that the initial draft SENE rule concept introduced to the NEM, with few, if any, positives that it provided. These negatives were present in all five options canvassed by the AEMC.

These negatives introduced increased complexity, a loss of generation competitive neutrality and a muting of generator locational signals – all elements that are addressed in the current market based approach to new generator connections.

The MEU concurs with the AEMC's analysis of the downside elements that the initial draft rule (and the options considered for more analysis) would have resulted in. The AEMC has identified that these downside elements were not offset by any significant upside elements. In its investigations, the AEMC has identified that there would be an increased benefit to new generators by the provision of more information.

The MEU agrees with the AEMC in its analysis and conclusions and supports the new draft rule proposal.

3. MEU views and conclusions

Since it was first mooted by the AEMC in its review of Energy Market Frameworks in light of Climate Change Policies, the MEU has been a consistent opponent of the approach to have consumers liable for risks and costs resulting from the scale efficient network extension concept. The reasons for the MEU's opposition were detailed in its responses to the second interim report on the AEMC review of Energy Market Frameworks, to the initial draft rule and to the options paper prepared by the AEMC. The MEU has also provided its views in various forums established by the AEMC to discuss the SENE concept.

Consistently, the MEU has supported an approach which is based on the current arrangements for new connections, albeit with additional information being made available, and network providers being able to negotiate concurrently with multiple parties seeking to connect.

The MEU has been opposed to consumers being required to take the risk of asset stranding and to carry the costs of surplus capacity created in the expectation of additional generators seeking to connect to the shared network at some time in the future.

The MEU welcomes the AEMC new draft rule which retains the process in the existing rules for new generator connections. The rule will be enhanced to require network service providers to publish better and more extensive information about the potential for multiple generator connections in a particular geographical location and, by allowing the network extension details and costs to be negotiated, to allow the network provider to earn a higher rate of return to offset the potential risk of the asset being part stranded.

Essentially, the AEMC new draft rule allocates the risk and reward to those best able to manage the risk associated with a SENE.

The MEU fully supports the new draft rule as proposed by the AEMC.