

3 August 2009

Dr John Tamblyn
Chairman, Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235



Dear John

Second interim report

Thank you for the opportunity to provide a submission on your second interim report.

The Energy Users Association of Australia has a strong interest in the AEMC's proposals, which will have important impacts on our members.

The attachment sets out our positions on the various issues canvassed in your second interim report. In summary we are concerned about the proposals on network connection, and the absence of a deeper consideration of market design. We do, however, support many of the proposals on other issues.

We would be pleased to discuss the contents of this submission with the AEMC in due course.

Yours sincerely

A handwritten signature in black ink, appearing to read "Roman Domanski".

Roman Domanski
Executive Director



Submission to AEMC on the Second Interim report on the Review of Energy Market Frameworks in light of Climate Change Policies

3 August 2009

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Introduction

This document is the Energy Users Association of Australia's (EUAA) submission on the Australian Energy Market Commission's (AEMC) second interim report. It sets out our views on the AEMC's interim proposals and recommendations on:

- Connection of remote generators;
- Efficient utilisation and provision of the network;
- Constraint management incentives;
- Inter-regional settlement residues
- Short term risk management
- Long term risk management

Connection of remote generators

The AEMC's proposal is that the connection of remote generators to the transmission system becomes a regulated service, rather than a contestable service as it currently is. You have argued that this is appropriate because failure to administratively co-ordinate the connection of remote generators would mean that connections would be undersized, and so economies of scale would not be realised. Your argument is that consumers would benefit from the economies of scale attributable to administrative co-ordination and so should assume the downside risk that expected future demand might not eventuate. In addition, you have argued that transmission network service providers should have a monopoly over the development of connection assets serving remote generators.

We do not support any aspect of the AEMC's proposals in this area, and strongly suggest that this be re-thought. Our concerns are as follows:

1. Firstly, we are not convinced that there is a co-ordination problem that requires administrative intervention. You have suggested that the renewable electricity generators are likely to be concentrated in particular areas (where the wind blows and geothermal and solar resources are available). If such generators are likely to be concentrated in specific areas then we see no compelling reasons why developers would not co-ordinate amongst themselves to develop connection assets that achieve economies of scale. Under the current arrangements they have strong incentives to do this since generators bear the costs of connection.
2. Second, it is not clear that administrative co-ordination will be more efficient. The benefits of economies of scale are countered by the usual detriments associated with monopolies – dynamic and productive inefficiency. We have no confidence that the proposed regulatory arrangements are able to adequately mitigate these detriments.
3. Third, even if it could be demonstrated that administrative co-ordination would allow economies of scale to be realised and that the benefit of this exceeds the detriments of monopoly, the main (and concentrated) beneficiaries of this are the newly connecting generators, not energy users. Since these market participants benefit, they should bear the risk of inefficient over-building, not energy users.

4. Fourth, your proposal is likely to discriminate amongst renewable generators. For example, biomass generators that are not remotely located will receive less favourable treatment than wind or geothermal generators located within the designated connection zones. We can see no justifiable argument for such discrimination.
5. Fifth, we are sceptical that the concept of specific zones in which special connection arrangements will apply, is workable. How is the connection of a non-renewable generator located within a NERG zone to be treated? What will happen to the many wind, biomass and possibly solar thermal plant that will be remote from the grid but not within the designated zones?
6. Finally, we strongly believe that if the connection of generators to the transmission system is to become a prescribed service, transmission network service providers should not have a monopoly in constructing these assets and that they should rather be procured from contestable asset developers.

In summary, it is all too easy to “solve” a perceived problem by shifting risks onto energy users. This is no solution at all. It is simply a recipe for the sorts of productive and dynamic inefficiency that reforms of Australia’s electricity industry were meant to reduce. Our view is that the AEMC’s proposal would be a big step in the wrong direction. We think the AEMC should be looking for opportunities to reduce the scope of regulation and monopoly, not increase it. The AEMC must also have regard to the national objective but we believe that the current proposal is not justified on this ground either.

Nonetheless if a convincing argument can be made that there are likely to be diseconomies in connection attributable to co-ordination failure and that such diseconomies can be effectively reduced through administrative intervention, then we accept that there may indeed be a role for some form of regulated oversight. However, the connecting generators not the general body of energy users should be exposed to the risks that arise as a result of this, since they are the primary, and concentrated beneficiaries of administrative co-ordination. We would like to suggest that the AEMC reconsiders its proposals in this area along these lines, and we are prepared to work with the AEMC to develop innovative solutions that correctly align risk with reward and thereby provide appropriate incentives for the parties involved.

Efficient utilisation and provision of the network

We support the proposal to introduce transmission use of system (TUoS) charges for generators. The failure to allocate transmission use of system costs to generators has been a major flaw in the NEM, and your proposal correctly seeks to deal with this. However we don’t agree with your recommendation that the scheme should be revenue neutral for generators. You have asserted that redistribution of costs from load to generators would be “disruptive” to generators. We are convinced by this – why would cost redistribution be any more disruptive than the introduction of TUoS charges (a generator that pays a dollar of TUoS will be unable to distinguish whether this dollar found its way to another generator - under your proposed revenue neutral arrangement - or whether it reduced the direct contribution that energy users make to transmission charges). You suggest that if it is appropriate to expose generators to use of system charges (as you correctly have concluded) then why not ensure that this payment is a genuine payment of transmission costs, rather than just a wealth transfer amongst generators?

We think there are efficiency and administrative simplicity arguments for generators to properly share in charges for the use of the transmission system:

- The efficiency argument is that requiring generators to pay for TuOS properly involves generators in the debate on transmission costs – just as users are. This is likely to enhance the ability of market participants to pressure both transmission network service providers and the AER to ensure that the operation and development of the transmission system by the monopoly transmission network service providers, is efficient.
- The utility argument is that by making the TuOS charges a genuine contribution to the remuneration of transmission expenditure, it is possible to maintain the same relative differential in locational transmission charges, but without ensuring that some prices are negative (i.e. payments from transmission network service providers) as is necessary under your proposed revenue neutral scheme. Negative prices are unavoidable under the proposed revenue neutral arrangements. We think such payments are likely to be highly undesirable from the perspective of the additional administrative costs that they are likely to give rise to.

Constraint management incentives

We note your proposals to consider constraint management incentives. We support continued examination of this, but encourage you also to consider the impact of any such incentives on the liquidity of contract markets. A gain in more accurate targeting of constraint costs could, depending on the way that the incentive is constructed, come at the expense of the loss of liquidity in contract markets.

Inter-regional settlement residues

We support your continued examination of ways to improve the sale of Inter Regional Settlement Residues as a risk management instrument. We note the idea to possibly provide external funds as to strengthen incentives. Your intentions on this are not clear, but for the avoidance of doubt we oppose the creation of any sort of fund to be financed by energy users for this purpose.

Inter-regional transmission charging

We support the proposal to improve transmission charging arrangements by the introduction of charges for the use of network assets in adjoining regions. However, we can see no good reason why such charge should not also be extended to generators. The beneficiaries of power flows across regions are generators in exporting regions and energy users in importing regions. Your proposal only deals with energy users. Generators that benefit should be charged for the use of network elements that enable inter-regional power transfers.

Short term risk management

We will reserve our views on the short-term risk management arrangements, pending the decisions of the Reliability Panel. However, we would like to reiterate the comment we have made in previous submissions, that we think the separation of risk management into short term and long term is a contrived distinction that misrepresents the true nature of the problem. The issue here is market design. An effective market design produces suitable outcomes in both the short and long term. Changes to the market design to deal with perceive short-term challenges, also has implications for

the long term, and vice versa. In other words, the issue of risk management for both the short and long term should be dealt with holistically as a market design issue.

Long term risk management

The point above about holistic consideration refers, and we would also like to articulate our concern that the AEMC has not rigorously considered the issue of market design. We think your conclusions on long term risk management are internally inconsistent, and they rely on assertion rather than evidence-based analysis. The introduction of emission prices and the impact of the RET is likely to mean a switch to more capital intensive renewable plant, with relatively higher capital costs and lower operating costs than fossil fuel generating plant. This is a fundamental change, although the timing of it is uncertain. In the absence of a deeper and a wider consideration of market design issues, we are not persuaded by your conclusion that no fundamental change is justified.

The internal inconsistency in the analysis relates to the conclusion that the spot market has delivered sufficient generation capacity (see page 125). This appears to be contradicted by the proposals for various measures of “short term risk management” to provide insurance against expected capacity shortfalls in Victoria and South Australia. This suggests that you have concluded that the market has failed and that administrative mechanisms should be strengthened to ensure supply security. Specifically we interpret your focus on various forms of intervention (Instructions, Directions, and reserve capacity contracting) as demonstration of your real belief that, actually, the market has failed to deliver sufficient capacity.

In addition, you concluded that the NEM has an “active and flexible capacity market” but then note a scarcity of contracts and that a number of market participants told you that they are concerned about the high cost and limited availability of electricity supply contracts in the current market. You attribute this to “policy uncertainty”, in the absence of which you think that changes to the market design are not warranted.

It appears that you assume that policy certainty will soon be available. We think this confidence is misplaced. Carbon markets and renewable electricity markets are politically contrived markets, and therefore subject to high degrees of political risk. The evidence of this can be seen in the developments in the EU Emission Trading Scheme, the New South Wales Greenhouse Gas Abatement Scheme, and the Mandatory Renewable Energy Target. An examination of both prices and developments in these markets demonstrates their unpredictability, and their susceptibility to stochastic political decisions. Political risk is very hard to hedge. The AEMC should clearly state where this policy certainty will come from and why.

It seems to us that a fundamental issue for the design of the NEM is the extent to which it is able to cope with continued uncertainty in emission reduction and renewable electricity policy. Your conclusion appears to be that so far it has not coped well. We think it is realistic to work on the assumption that such uncertainty will be enduring rather than taking the more optimistic position that this will change.

We also think it would be worthwhile for the AEMC to extend its examination of the market design issue by developing evidence on:

- The liquidity of contracts of various forms in the exchange-traded, bi-lateral and over-the-counter contract markets. This should include an analysis of the number of market participants and volumes of trades in each of the NEM regions;
- The effectiveness of the sale of Inter Regional Settlement Residues as a hedge on inter-regional price variation;
- The extent of inter-regional electricity trade, and regional vertical integration of production and supply;
- The success with which new entrants have been able to access the energy market without needing to vertically integrate production and supply;
- The volatility of energy prices and the extent to which contract markets have been able to effectively predict future spot prices;
- Why there is so little demand-side participation in the wholesale market.

More generally, we would encourage you not only to consider the market from the perspective of its treatment of capacity and energy payments, but also from the perspective of the mandatory requirements for market participants to participate in spot markets. Amongst electricity markets in the world, only the New Zealand Electricity Market and the NEM make participation in the prompt (spot) market compulsory. The predominant model internationally has no compulsory participation in spot markets. The British electricity market changed from a mandatory, centrally settled spot market to a voluntary market in 1999. Why is this and what has been the result? Is there merit in considering a similar change in Australia? These matters are not addressed in the AEMC's report but the importance of this matter to the future performance of the NEM and its impact on energy users in terms of the market objective require that the AEMC's review needs to address them and clearly set out its conclusions with strong supporting evidence.