



ERM Power Limited
Level 3, 90 Collins Street
Melbourne VIC 3000
ABN 28 122 259 223

+61 3 9214 9333
ermpower.com.au

Tuesday, 4 September 2018

Dr Kerry Schott
Chair
Energy Security Board

Dear Dr Schott

RE: National Energy Guarantee reliability requirement pre-condition options

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Energy Security Board's (ESB) consultation on the National Energy Guarantee (the Guarantee) reliability requirement pre-condition options.

About ERM Power

ERM Power is an Australian energy company operating electricity sales, generation and energy solutions businesses. The Company has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load¹, with operations in every state and the Australian Capital Territory. A growing range of energy solutions products and services are being delivered, including lighting and energy efficiency software and data analytics, to the Company's existing and new customer base. ERM Power also sells electricity in several markets in the United States. The Company operates 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland. www.ermpower.com.au

General Comments

ERM Power is disappointed that fundamental design questions are being raised at this stage given the extensive consultation and work done to arrive at a well-considered design. We believe it is unnecessary and even damaging to continue to question how the reliability requirement will be triggered after setting out the T-3 and T-1 system in the detailed design. Making compromises at this late stage only serves to undermine the work already done and adds to the uncertainty facing the energy industry.

Policy certainty is crucial to industry in the energy sector given the disarray we have seen over the past decade and indeed the last fortnight in particular. The ESB has presented three options, none of which provide certainty and two of which actively risk enhancing the market power of existing large vertically-integrated gentailers and increasing prices. ERM Power considers it imperative that all three options are rejected and the original position of a T-3 trigger followed by confirmation at T-1 is retained.

Each of the three options presented creates the risk of 'gold-plating' the NEM's generation fleet by installing assets that are not needed given the existing supply-demand balance. As highlighted in the ACCC's recent report into electricity prices, increases in costs for network investments has led to large increases in prices for consumers. Much of this investment was to cater to peak demand that has not eventuated. It would be concerning if this pattern were to be repeated in the generation sector. ERM Power considers that the T-3 trigger provides an appropriate balance between encouraging investment in generation when needed to meet reliability and avoiding the costs

¹ Based on ERM Power analysis of latest published financial information.



associated with unnecessary investments. The T-3 trigger also aligns with the AEMC's draft determination that generators give three years' notice before closing. We caution the ESB against making changes to the National Energy Guarantee that could inadvertently increase prices for large and small energy users.

Addition of a T-5 trigger

Of the three alternative options the ESB presents, the addition of a T-5 trigger instead, or in advance of a T-3 trigger appears to be the least costly and distortionary. This does not mean that ERM Power supports this option. It still carries the real risk of higher costs with it.

The ESB has highlighted that state governments are concerned that a reliability gap could arise at any point during the 10-year forecasting window. We acknowledge this as well, but fail to understand why the originally proposed T-3 and T-1 triggers are not sufficient. A gap that arises further out, for instance 5 or 6 years in advance, signals to the market that more generation may be needed. Investors will take action accordingly and have a number of years to act before there may be a risk to reliability. Forecasts are also likely to improve the closer to the present they are made. The history of AEMO's ESOO forecasts shows demand forecasts are highly uncertain further out from the present. We therefore consider it unnecessary to shift to a trigger period further out than 3 years.

As we see it, the purpose of the T-3 trigger is to formally signal that new investments may be needed to ensure that the reliability standard is met. That does not preclude investments being made in advance of that. A gap that appears well before that time would still be flagged in AEMO's Electricity Statement of Opportunities and signal to the market that investments in new capacity may be needed. Investors could respond at any time; investments in generation can be made at any time, with or without a reliability guarantee in place. Declaring that action is needed three years before a potential gap signals to retailers (or large customers who have opted in) that they must start taking action be that through increasing their hedges or investigating demand response options or installing generation such as battery storage or gas generation.

At first glance, it may appear that making this declaration five years out would provide additional time to develop new generation assets and consequently help improve reliability. However, ERM Power contends that in reality it is unlikely to lead to investments until closer to the T-1 period. This is due to the inherent uncertainties of demand forecasts which will be used to determine reliability gap periods.

Retailers and other liable entities may respond to a T-5 trigger by entering into hedge contracts, but this will lead to hedging levels above usual levels, which will likely entail higher costs as retailers commit financial resources earlier than they ordinarily would. Furthermore, contract markets are very thinly traded five years in advance. It may therefore be difficult to access contracts at this time and as such, non-vertically integrated retailers will face a choice between contracting further out at higher prices, waiting and facing the risk of penalties for not meeting the reliability obligation, or investing in capital resources which may ultimately not be needed.

Based on all of this, while ERM Power understands that some parties may see benefits in having a T-5 trigger instead of T-3, we do not see that it will lead to greater benefits than a T-3 trigger and could in fact lead to higher costs. As such, ERM Power calls on the ESB to retain the originally planned T-3 and T-1 arrangements.

Finally, we wish to address the prospect raised in this section that "If the Rules provide for it, AEMO would also be able to request a T-1 reliability instrument be made without a T-3 or T-5 determination".² As we will explain in our commentary on the removal of the T-3 trigger option, allowing for a trigger at T-1 with no previous warning is unacceptable and carries with it serious risks for retailers, and in particular, non-vertically integrated retailers. ERM Power strongly opposes any option that could lead to a reliability guarantee being declared without a previous

² Energy Security Board, 'National Energy Guarantee Reliability Requirement Pre-condition Options' p4.



trigger at T-3. A reliability gap that arises inside of the three-year window can be dealt with using a well-designed RERT rather than exposing retailers to the risk of significant penalties.

Removing the T-3 trigger

In our submission on the high-level design document, ERM Power argued that relying solely on a T-1 trigger adds significantly to risks for retailers and large users of an over contracted market. Under this option, the reliability requirement would effectively be in place permanently unless declared otherwise at T-1.

Consequently, this would mean that retailers and large customers would have to form their own view of how likely a gap is to occur and manage their contracts accordingly. In the event of force majeure event, such as a flood at an open cut coal mine, leading to an unanticipated gap due to reduced supply, some retailers could be exposed to significant penalties. A reliability guarantee designed in this manner would create a perpetual cost in the market as retailers would have to factor in the risk of a reliability gap being triggered in any given year.

A one-year trigger period is more akin to a capacity market, albeit one which brings with it the risk of severe penalties. If a capacity market were the preferred option to manage reliability on the NEM, then it would be better to consider that as an option. However, ERM Power takes the view that the decision to adopt the reliability guarantee rather than a capacity market is well founded on the basis that a reliability guarantee focuses on times where the supply-demand balance is tight, rather than a capacity market which imposes a cost for procuring capacity (separate to energy) at all times.

Furthermore, only triggering the gap at T-1 would serve to enhance and entrench the power of the existing large vertically integrated gentailers. This is because retailers would essentially need to be hedged to their one-in-two year demand level at all times and for more than 12 months in the future. For vertically integrated gentailers, this would mean they could hold onto internal hedges and only start to sell meaningful volumes into the market if no gap period was declared. Essentially, vertically integrated gentailers would assign themselves a 'swaption' designed to be exercised if the gap period is triggered.

Gentailers with large baseload plant tend to contract all but one of the units they control. They generally do so to ensure that if there is a breakdown at another unit, they are able to generate enough electricity to meet their contracts. Under a situation where the trigger period only occurs at T-1, they could use the headroom of this uncontracted unit to cover unpredictable load increases by customers, or load from new customers, without the risk of penalties. This puts vertically-integrated gentailers at a significant advantage and would further entrench their market power in the NEM. Applying the Market Liquidity Obligation at all times would be one way to partially remedy this if the T-3 trigger is removed.

ERM Power urges the ESB to reject this option due to the likelihood that it will further entrench market power of gentailers, and thus reduce competition, and lead to price increases. It is for this same reason that we also oppose the prospect of AEMO being given the scope to request a trigger at T-1 without a previous T-3 trigger.

Ministerial power to trigger the reliability obligation

ERM Power strongly rejects the proposed option to allow Ministers for each of the NEM-regions to make a T-1 reliability instrument for their region at any stage. Furthermore, the ESB's suggestion that "[a] material reliability gap would not need to be present for the Minister to make the determination and there would be no limit to how far in advance the determination could be made"³ is completely unacceptable.

³ Energy Security Board, 'National Energy Guarantee Reliability Requirement Pre-condition Options' p5.



One of the key problems for the energy sector over the past decade has been the continual interventions of governments into the market based on little if any evidence. This option places government intervention at its heart, would provide absolutely no certainty to the industry, would impose the costs of managing an opaque and continual risk, and would make triggering a reliability gap a political decision rather than one based on evidence. Undoubtedly, this option would politicise the decision of whether or not to trigger a reliability gap, rather than allow for experienced energy market bodies to make the decision based on the evidence they have available. The costs of unnecessary triggers would be imposed on all energy consumers for no real benefit to reliability. ERM Power does not see how this option warrants any further consideration.

Conclusion

ERM Power calls on the Energy Security Board to retain the method proposed in the final design of the National Energy Guarantee for a T-3 trigger followed by a T-1 trigger. Making compromises at this stage, following the ESB's exhaustive consultation and design work, would be counter-productive. The three options presented are all likely to significantly increase risks to retailers and therefore add costs to end-users and may in fact only serve to enhance the market power of the large, vertically-integrated gentailers.

In addition, while not specifically consulted on as an option, the paper raises the prospect of AEMO being able to request a trigger at T-1 without a previous trigger being made. This would be an unacceptable outcome that is unlikely to improve reliability and may only lead to increased costs. ERM Power firmly believes that all options being canvassed are incompatible with one of the stated aims of the National Energy Guarantee to help bring down electricity costs.

Please contact me if you would like to discuss this submission further.

Yours sincerely,

[signed]

Ben Pryor
Regulatory Affairs Policy Adviser
03 9214 9316 - bpryor@ermpower.com.au