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Dr Kerry Schott
Chair
Energy Security Board

Dear Dr Schott

RE: Retailer Reliability Obligation Legislative Amendments

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Energy Security Board's (ESB) consultation paper on the Retailer Reliability Obligation Legislative Amendments.

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. The Company operates 662 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland.

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General Comments

ERM Power welcomes the ESB's move to release a new exposure draft of legislative amendments relating to the Retailer Reliability Obligation. As we stated in our submission in September, the uncertainty around the National Energy Guarantee as a whole meant that it was challenging to respond. We note the various changes that the ESB has made to the previous set of legislative amendments and are pleased that some of our concerns and those of the wider market have been addressed.

Nonetheless, we maintain that it is essential that all three aspects of the energy trilemma – affordability, emissions and reliability – are managed together. A piecemeal approach will only see a return to the uncertainty and risk that have become the hallmark of the past few years of energy policy. Despite the various market reviews and recommendations that have called for this to occur we are still a long way off. Parts of the Finkel Review's recommendations – on reducing emissions and the generator reliability obligation – have been ignored and we believe that they should be considered as part of the overall reform process.

The legislative amendments require a large amount of scheme design to be determined as part of the National Energy Rules (the Rules). At one level this is a sensible approach as it allows for the Rules to change as needed through the well-understood rule change process managed by the Australian Energy Market Commission. Many of the issues to be resolved in the Rules are of particular interest to market participants such as the definition of qualifying contracts, opt-in arrangements, adjusting the net contract position and forecasting reliability gaps. Given the desired start date of 1 July 2019, this leaves comparatively little time for the Rules to be developed and consulted on. This creates the risk of Rules being developed in a hurried fashion leading to unintended

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



consequences and poor outcomes. Instead, ERM Power considers that there should be a delay to the intended start date to 1 July 2020 in order to allow for adequate time to consult on the Rules to ensure that liable entities have a full understanding of how to manage their obligation.

Furthermore, we encourage the ESB to be mindful of the impact that a badly designed obligation will have on the costs that consumers face. The ESB points to the benefits of contracting in that when retailers contract with generators, generators are incentivised to make supply available to the market and bidding into the spot market at a level to ensure it is dispatched by AEMO. This is sound logic. Low spot prices will be reflected in lower contract prices in the future (subject to expectations about the future supply-demand balance).

This is only part of the equation though. Customers are priced not on the spot price now but on expectations of future prices, which contracts can represent. If retailers are driven to contract more, the supply-demand balance of the contract market will change. As this tightens, which it may if retailers are required to enter into more contracts, contract prices will rise. This will then be reflected in higher prices for consumers. ERM Power contends that the ESB needs to find a balance in designing the Retailer Reliability Obligation (RRO) that provides incentives to retailers and large users to contract but does not lead to over-contracting. We firmly believe that this can be achieved by ensuring that the reliability gap is a targeted set of trading intervals, allowing for various types of contractual arrangements, and providing flexibility for liable entities to adjust their contract positions over time.

In addition to the development of the RRO, there is a series of other interconnected policy processes underway in the electricity market. Consultation processes and policy development are underway on issues including the implementation of recommendations from the ACCC's final report into electricity prices, the development of a demand response mechanism, enhancements to the Reliability and Emergency Reserve Trader (RERT) provisions, and the development of a Short-Term Forward Market. All of these issues will impact each other in some way. It is crucial that they are considered in a holistic fashion rather than as individual pieces of work. We encourage the ESB and the COAG Energy Council to work closely with the AEMC, AEMO and Federal Government to ensure that the Retailer Reliability Obligation complements these other processes.

The submission that follows outlines ERM Power's views on specific sections of the legislation.

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

Yours sincerely,

[signed]

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T-1 trigger without a previous T-3 trigger

We wish to reiterate our concerns about the potential for AEMO to request a T-1 trigger without a T-3 trigger having previously been made, as allowed for in Clause 14H, paragraph 2. ERM Power understands the ESB's stance that this is necessary because "some flexibility is required to allow for changing market circumstances where the market is undergoing a transition". Yet, we firmly contend that the declaration of a T-3 period is necessary to provide the market with a signal to begin investing or contracting in the event a T-1 period is declared. Without this warning, retailers will be driven to over-contract and potentially over-invest in generation beyond what is economically efficient. This will raise costs which inevitably be passed onto consumers.

There is a case to be made that the ability to have a T-1 trigger without a preceding T-3 instrument could be useful as for a transitional period in the initial two to three years of the RRO until both a T-3 and a T-1 trigger can be declared for a region. However, as AEMO has access to the Reliability and Emergency Reserve Trader (RERT) arrangements to manage reliability concerns until a full 3 years' notice can be provided, the case for transitional arrangements is weak at best.

Beyond a transition period as described, ERM Power does not consider that a scenario exists whereby a gap period can occur inside the T-3 window where retailers have the ability to manage this risk. As we stated in our submission on the previous set of draft legislative amendments, the most plausible way this could occur would be due to the sudden and unexpected closure of a large generator along the lines of the Hazelwood and Northern Power Station closures. However, the AEMC has recently made a rule change that requires generators to give three years notice before closing, which mitigates against this risk to some extent. A sudden gap could also occur via a catastrophic failure of a plant due to accident or natural disaster. If this were to occur and lead to a reliability gap, there is little any retailer could do at short notice to 'close' the gap. Most, if not all, retailers would probably find themselves unable to secure enough eligible contracts in such a situation. Triggering a reliability gap period would only therefore penalise retailers who would fundamentally be unable to comply with the RRO's requirements.

Furthermore, ERM Power considers it entirely unnecessary that a gap period be declared less than three years out given that AEMO has access to the RERT to secure emergency, short-term generation should it be needed. This is the current 'backstop' in place to deal with reliability concerns at short notice. While ERM Power has concerns about the operations of the RERT, it would be far less damaging than the imposition of sudden and costly regulatory requirements at the risk of significant penalties to retailers and large energy users. The T-3 trigger is essential to allow liable entities to take action and invest in new supply arrangements in advance of a projected shortfall. Without this, the cost to manage risks will increase significantly and inevitably will see electricity costs increase.

Obligation to have contracted sufficiently for one-in-two year peak demand forecast

Clause 14R sets out that liable entities must have contracts that represent their share of the one-in-two year peak demand forecast during any trading interval that exceeds this forecast peak value. This is the position the ESB set out in the detailed design of the National Energy Guarantee. ERM Power believes it represents a balanced approach between incentivising early contracting and avoid the costly risks of driving over-contracting.

To further avoid the risks of over-contracting, it is essential that the gap period be a targeted period of time that provides clear signals for when and where additional supply may be needed. ERM Power believes it should take the form of something similar to '6-8pm, on working weekdays in NSW, during weeks 3-6 of Q1 in 2023' rather than a broad-based approach that applies to all of Q1, 2023 in NSW.

Throughout the design process of the reliability obligation, ERM Power has steadfastly argued that the reliability obligation must apply to a well-defined and targeted gap period rather than imposing a broad requirement. While it is impossible now to state in what period a gap may occur in the future, a targeted gap ensures the right mix of innovative new technologies and infrastructure are in place and that over-build and gold-plating, which adds cost, are avoided.



Providing a narrow window incentivises various technologies to be available in the right places at the right times to target the specific periods of concern. It allows storage technologies like pumped storage or batteries to be fully available as well as guiding demand response providers of the times to be ready for dispatch. Large users who have opted-in may also be able to structure their business operations to shift demand to other times of the day.

In contrast, a broad requirement fails to provide this guidance meaning it is difficult for generators, new technologies such as demand response or batteries, and large users to plan their availability accordingly. This approach will add significantly to costs for consumers, undermining the goal of this policy to encourage reliable supply and reduce energy costs.

We believe that the benefits of a targeted gap could be safeguarded by removing the requirement in Clause 14K(3)(b) for the AER to accept AEMO's request for a reliability gap without modification. There may be cases where AEMO has sought to impose a reliability gap that is too broad in nature and does not adequately target the specific trading intervals where reliability is genuinely at risk. In such a case, it appears that the AER may be obliged to accept AEMO's request in its entirety rather than reject it. ERM Power considers it should be reasonable for the AER to be able to narrow (but not expand) a proposed gap period if it believes this is more beneficial to consumers. This could be done in consultation with industry stakeholders as well as AEMO to ensure that a sensible outcome is reached. Alternatively, AEMO could employ the RERT in situations where the AER has rejected a request for a reliability trigger on the grounds that it is too broad.

Adjusting net contract position

ERM Power supports Clause 14Q which provides liable entities with the ability to adjust their net contract position after the contract position day. This is an essential tool to manage shifting customer load, particularly for large users, without which there is a risk that consumers could be stranded, facing little retailer choice or facing higher costs if they are not contracted. Even small users could face less choice.

Additionally, large customers can change their business operations after signing a contract with a retailer. They may add a major new piece of equipment which will materially increase their demand. It would be a poor outcome if these businesses or retailers were penalised for increasing their electricity demand and therefore, the need for contracts to meet the reliability obligation. The inability to adjust net contract positions could therefore stymie economic growth. We are encouraged that the Government has recognised these issues and will allow liable parties to adjust their net contract positions.

The draft legislation does not provide specific detail on exactly how a liable entity will be able to apply to adjust its position or what the broad requirements are to be able to do so. We do not consider that this is necessarily a bad thing. Allowing for the Rules to determine this gives flexibility to further consult on the specifics and to allow for them to change over time.

However, this highlights the need to avoid rushing the implementation of the legislation. Retailers and other liable parties need to understand how to manage their obligation and how customer contracting can function under the RRO before it enters into force. The design of the opt-in provisions detailed above will also need to fit in to how retailers (and large users) are able to adjust their net contracting positions.

Procurer of last resort

The draft legislation sets out that AEMO may act as the procurer of last resort in the event a T-1 reliability instrument is declared. ERM Power understands that this would operate similarly to the existing RERT. According to the draft legislative amendments, AEMO would be able to recover costs from participants who have breached their requirements to have contracted to meet their share of peak demand. In theory, this is a sensible response to ensure that parties that have met their requirements do not foot the bill for those who did not comply.



However, we are troubled that participants could face costs of up to \$100 million per region under this provision. We believe this to be manifestly excessive given that the cost recovery would be in addition to the civil penalties that participants would already incur. Furthermore, given that cost recovery occurs per NEM region, it is conceivable that cost recovery could be even higher. This has the potential to put some retailers out of business, or, if costs are ultimately recovered from consumers, lead to exceptionally high costs for energy users. Neither of these outcomes are desirable for the market.

We recommend that in the event of non-compliance, costs be recovered via civil penalties, or be related to the shortfall in a readily understandable term for the market e.g. in terms of \$/MWh. If a liable entity was 10 MW short of their requirement for a two-hour period, this penalty would then be 20 MWh at the penalty cost. This level could be set at or higher than the market price cap (currently \$14,500/MWh) to incentivise liable entities to avoid exposure to the spot price and instead enter into contractual arrangements. This approach would also place a transparent price on the cost of reliability, therefore providing a price signal for the banking of new capacity, such as battery storage, demand response or other technologies.

Opt-in for large users

ERM Power supports Clause 14E which provides large users with the ability to opt-in to manage their own reliability obligation should they choose to do so. Such an arrangement gives large users the flexibility to find an arrangement that best suits their needs.

Given retailers face significant penalties if they do not comply with their obligations, it is essential that there is a clear and efficient process to inform retailers when a customer has chosen to opt-in to manage their own requirements.

The ESB's consultation paper also notes that as part of the opt-in process, users may opt in to a part of their obligation. We believe that further work is needed to determine precisely how this will work in practice. ERM Power is of the strong opinion that the best way to achieve this would be to allow users to opt-in to specific National Meter Identifiers (NMI). Users would be able to choose which NMIs they opt-in but would be required to take on the entirety of that NMI's load. Allowing for a partial opt-in of individual NMIs creates costly challenges for retailers' systems and for forecasting and managing the reliability obligation.

A single NMI opt-in approach would require carefully designed rules to prevent customers from shifting significant loads from one NMI to another in order to minimize their own requirements. This would shift an unexpected compliance obligation onto a retailer managing a customer's other NMIs without the benefits of increased contracting or supply arrangements.