Major Energy Users Inc.

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The Chairman
Energy Security Board
C/- CoAG Energy Council

Sent by: email to info@esb.org.au

National Energy Guarantee
Response to Draft Detailed Design Consultation Paper – 15 June 2018

1. Introduction

The Major Energy Users Inc (MEU) welcomes the opportunity to provide its views on the Energy Security Board (ESB) Draft Detailed Design Consultation Paper dated 15 June 2018. The MEU responded to the February consultation paper and more recently to the June Commonwealth consultation paper addressing elements of the emissions leg of the National Energy Guarantee (NEG).

The MEU and its regional affiliates have been advocating on behalf of energy consumer interests for over 20 years and they have high recognition as providing informed comment on energy issues from the viewpoint of consumers with various regulators (ACCC, AEMO, AEMC, AER and regional regulators) and with governments.

In its response to the February consultation paper, the MEU commented

> "The ACCC has already highlighted that the NEM is highly concentrated and as a result, prices are higher than would occur under a more competitive market. As highlighted in the consultation paper, there is a concern that the NEG could very well entrench the power of the dominant retailer/generators, raise barriers to entry of new retailers and increase the difficulties that second tier retailers will face under the NEG. Combined, these aspects will further reduce competition."

The MEU also pointed out that there is a need to ensure that the NEG delivers outcomes that accord with the National Electricity Objective (NEO). In this regard the MEU notes that there is no reference to the ESB assessing whether the increased reliability obligation and approach to emissions meets the requirements of the NEO in terms of price, reliability, quality and security of the supply of electricity.

The MEU observation made in its response to the February consultation reflects the recent ACCC report on the retail electricity market enquiry and the comment by ACCC chairman Rod Sims that[1]

> "The National Electricity Market is largely broken and needs to be reset. Previous approaches to policy, regulatory design and competition in this sector over at least the past decade have resulted in a serious electricity affordability problem for consumers and businesses."

With this in mind, the MEU considers that the NEG is merely another "add on" to the NEM to address a specific concern, when what is needed is a review of the entire market structure and its rules to ensure that it delivers what was promised in the late 1990s. Tinkering with the rules does not address the basic issue identified by the ACCC.

The MEU points out that the electricity market failure is a result of the poor rule making enacted under the auspices of the CoAG Energy Council and the decisions made by state governments when they elected to sell electricity assets for the highest price rather than ensuring that the competition that was to underpin the entire operation of the NEM would be enhanced. As a result, it is consumers that have borne the brunt of this market failure.

The ACCC comments in its report (page viii):

> "To the extent that [the NEG] policy can encourage investment in capacity from a diverse range of sources, diluting market concentration and promoting competition to supply retailers, the policy should assist in delivering electricity affordability."

What is not clear is whether the NEG will actually result in encouraging new capacity from sources other than from the dominant market players and so increase , noting that the dominant market players are those most exposed to the requirements of the NEG and will therefore invest to match their own liabilities, further entrenching their market power. The MEU sees nothing in the NEG detailed design that increases competition but it does see there are aspects where competition might well be reduced; this concern is developed more in subsequent sections of this response.

At a high level, the MEU remains unconvinced that the detailed design:

- Achieves a position where the already excessively low competition in the NEM will not be further reduced
- Will not erode much of the savings that the ESB forecasts will result from the introduction of the NEG as a result of the increased complexity inherent in the approach
- Delivers a mechanism where there will be competition in the delivery of demand side responses needed to minimise costs

[1] ACCC press release 11 July 2018

The MEU is also very concerned that the detailed design has introduced a new feature where end users with a demand > 5 MW will be required to manage their own reliability requirements. On deeper analysis based on what the load shapes of large end users are, the MEU is concerned that this new requirement will result in increased costs due to unnecessary contracting for reliability obligations.

The MEU develops its concerns on each of these concerns later in this response.

2. Emissions

While the MEU can see that the approach outlined for managing the emissions leg of the NEG are workable and will act to limit the ability of Market Customers to exercise market power, the MEU is concerned that the process is not transparent in that data in the registry is limited to AEMO, generators and Market Customers.

One of the features of the NEM is that its transparency of data provides all interested parties access to the data enabling them to identify if there is exercise of market power being used. Limiting access to information places a considerable burden on the AER to monitor the market and ensure there is no “gaming” occurring.

The ESB comments that third parties having access to this data imposes a risk that third parties might have generator output allocated to them but who are not subject to compliance requirements. The MEU finds this comment strange and the reverse should apply. If a non-Market Customer third party has generation allocated to it, that party should be aware of the fact so it can pass this information to its retailer such that its retailer can ensure it has adequate coverage. The MEU considers the ESB needs to allow third parties to access the information in the register.

The other major concern the MEU has is that the process is complex and data intensive. While the MEU is of the view that with the low emissions targets proposed, there will be no benefit from the NEG to achieve emissions reductions but the establishment and ongoing costs will be significant, increasing the premium already added by retailers to the direct costs they incur for providing electricity services to consumers. These establishment and ongoing costs will be greater (in proportion to the amount of electricity sold) for smaller retailers. While the MEU notes that these smaller retailers will have an exempt load of 50,000 MWh pa this is equivalent to perhaps the load from 10,000 residential customers, less from small and medium sized businesses and effectively a single large business with 6 MW continuous load.

This means that most Market Customers (notably retailers) operating in the NEM will all incur establishment costs and then manage their emissions obligations under this new approach, even though their proportional ongoing obligation might be less than that incurred by the larger retailers. The MEU considers that this will be a barrier to small retailers, and favour the larger retailers.

The MEU notes that the design allows for the Market Customer for a site to “own” the exported emission rights from power exported from embedded renewable generation

(including solar generation). The MEU is aware that a number of its members and other large users have or are contemplating installing large PV solar arrays. The MEU finds it concerning that the ESB considers that any export from these sources of generation are "owned" by the retailer delivering power to the site. As the assets have been paid for by the end user, the output should be "owned" by the end user and therefore be allowed to use this output to offset costs that it incurs, including those that a retailer (as the Market Customer) will impose on the end user as a result of the Market Customer's costs to acquire its emissions reduction.

With this in mind, the MEU considers that there should be an opt-out arrangement whereby an end user can elect to hold the output of its low emissions generation to itself rather than have it assigned automatically to its retailer. This approach would increase competition for the supply of low emissions generation.

Underlying the whole emissions reduction process is an increase in risk. Fundamentally, the NEG increases risk for Market Customers in terms of

- Forecasting the expected demand (needed to identify the level of renewable generation needed)
- Contracting with providers of generation that each will deliver the amounts of generation from each source to ensure the emissions intensity is below the target

The smaller the numbers of end users in a retailer's portfolio, the greater the risk that the forecast and the actual demand will vary as there is less diversity to manage variances. Similarly, a small demand will imply fewer supply contracts, again losing the benefits of diversity. This leads to the view that smaller retailers will face higher risks in percentage terms of non-compliance than larger retailers. As a reward is required to take on risk, the MEU is concerned that the increased complexity and increased risk due to penalties will lead to higher costs being passed onto consumers.

The MEU notes that there will be penalties associated with over-allocation by Market Customers. It is not clear that in the event that there is low/no emission generation still available in the market for purchase and the emissions reduction has exceeded the policy requirement, that there will be no penalties applied. It would be absurd to impose penalties if there is no reason.

The MEU has responded to the Commonwealth consultation paper and has expressed support for the application of the emissions intensive trade exposed (EITE) approach detailed in the Commonwealth paper. The MEU also supports the process included in the ESB consultation paper in its approach to managing the impact of incorporating EITE emissions and offsets in the obligation.

3. Reliability

The MEU has a number of concerns regarding the reliability leg of the NEG which are detailed below, but its overarching concern is that there will still be a loss of competition in a market that is already deemed highly concentrated by the ACCC.

The MEU accepts that the detailed design addresses some of the concerns the MEU raised about it lessening competition in its response to the high level design, but there still remains underlying issues inherent in the NEG where competition is reduced from the current already too low levels of competition (ie without the NEG).

While the introduction of the Market Liquidity Obligation does minimise some concerns about hoarding, there are still other aspects where the lack of competition in the market will still allow providers of qualifying contracts to set the prices above the costs inherent in their provision due to the low competition for their supply in each region.

In a highly concentrated market for the supply of energy, to add a requirement that liable entities have to contract for reliability from many of the same providers as for energy, does not increase competition but reduces it, as explained in section 3.1, with non-retailer liable entities having to source more reliable supplies than are required.

The MEU points out that the NEG processes (especially the reliability leg) have been rushed through under great time pressures (for example compared to the Finkel review) and this limited time will inevitably result in aspects which have simply not been identified, let alone considered. As a part of this concern, the MEU notes that there has been no further modelling carried out of the NEG since that done early in the investigation process. Certainly, there has been no modelling carried out to reflect the significant changes that have been made to the NEG processes as design changes were implemented, initially for the high level design and then for the detailed design processes.

This lack of modelling is particularly important when the NEG is considered in conjunction with the move to 5 minute settlement that is to occur in July 2021. The AEMC analysis of 5 minute settlement showed that this change will reduce liquidity in the market for $300/MWh caps which the NEG points to as being a specific source of reliability. The MEU is very concerned that this lack of detailed modelling could well introduce unintended consequences for the market in the future and which have not been highlighted due to this lack of modelling.

3.1 Liable entity threshold

To address the market failure that the NEG is intended to address, the ESB is proposing that large end users of electricity which mostly have high load factors are expected to make major changes to their operations and incur significant increases in costs to address market flaws that arose from earlier actions of governments (such as the sale of assets leading to increased market concentration) and poor law and rule making by officers appointed by them. As a group, even large energy consumers do not have the skills and are not well placed to manage the many risks in the electricity

market, yet the entire thrust of the NEG is to force those who did not cause the problem to solve a problem caused by others. This is inefficiency in the extreme.

The original concept of the NEG was that the liability for the reliability obligation would apply to Market Customers although there was a view expressed that larger customers with spot price pass through or expiring retail contracts would need to contribute to the reliability requirement. The more detailed design requires end users with a demand > 5 MW to independently be liable entities. The MEU does not consider that this proposal results in an efficient outcome and, in fact, might lead to a reduction in competition for the supply of reliability contracts.

It is important to stress that it is not large users that have caused the problem of any lack of reliability – if anything, they have been facilitators of the large amounts of dispatchable generation that do exist in the NEM. Large users are also a primary source of demand responses that exist in the market today and their actions have led to significant improvements in efficiency of the electricity market. Despite this, imposing this obligation on them by the electricity market does not reflect the reality that managing electricity market issues is a core function of retailers but it is not (and nor should it be) a core function of large end users of electricity. What other market requires buyers to be involved in the intimate processes of a supplier?

The MEU points out that almost all large end users access their electricity supplies (even those that take spot market risk) through a retailer to avoid the complexities and costs that are inherent in operating in the NEM. This reliability proposal now forces large end users to have to be involved in the electricity market, even if they don't want to. The reasons for imposing this risk are that in aggregate they are a significant part of the overall market demand. In its draft design consultation paper, the ESB comments (page 41)

> "The purpose of this approach would be to make sure that large customers that are exposed to wholesale prices via spot pass-through arrangements, or those customers who are on shorter-term or expiring fixed price contracts, still contribute to the reliability of the power system. **Large customers switch relatively frequently which would make it harder for retailers to contract under the Guarantee for their load**.
>
> As customers on spot price pass throughs bear the risk of spot price volatility themselves, retailers do not have an incentive to contract or maintain physical capacity for this load. Some of the customers do respond to high pool prices by reducing their load so this demand response also needs to be recognised. Similarly, for **customers on shorter-term or expiring fixed price contracts, obliging such parties to comply with the reliability requirement would create incentives to contract and support investment in new generation, which would potentially increase competition**.
>
> Any process to give effect to this would either need to identify customers on spot pass-through arrangements with retailers; or simply 'deem' customers above a certain size to comply with the requirement. Therefore, these businesses would then have similar obligations to retailers to demonstrate the extent to which their hedging strategy promotes a physical response (from themselves or others). **If this approach was**

adopted, these customers would still have the flexibility to transfer this obligation to a retailer via contracts increasing opportunities for smaller retailers to participate in the market." (emphasis added)

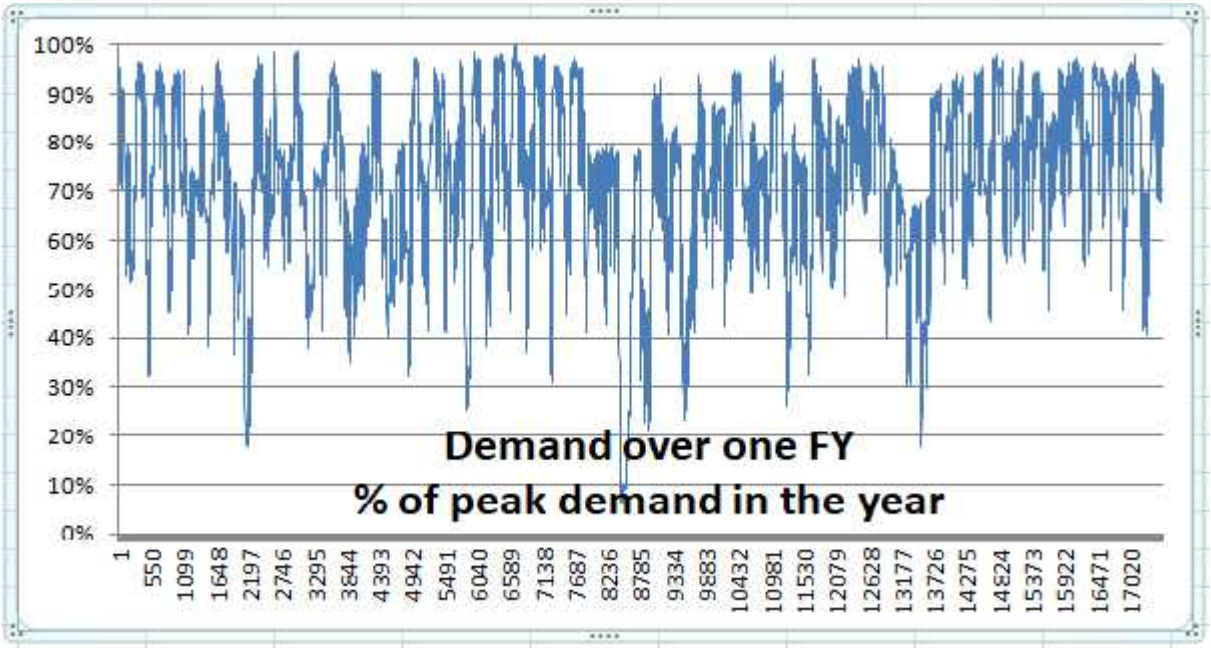
The MEU finds these arguments do not reflect the reality of what occurs in the market.

1. Retailers formally contract with those end users who take spot price exposure. This means that retailers not only have access to information about the electricity used by each end user (both historically and current) and their load profile, but also there is a cost (commonly a percentage of the total cost of the electricity purchased) for the retailer to provide this spot market exposure service. It would be a straightforward process for a retailer to adjust their contract costs to include for the reliability obligation when it is triggered. The fact that the observation considers that large end users could transfer their reliability obligation risk to retailers, merely reflects what already occurs in relation to electricity purchasing.
2. The assumption that, because large end users will be exposed to the reliability obligation, this will lead to increased incentives to contract and support investment in new reliable generation is not valid, because if the obligation lay with the end user's retailer, the same outcome would occur
3. Large end users tend to "churn" as much as smaller end users. The MEU notes that the annualised churn rates across the NEM are 25-30%[2]. Large end users tend to contract for similar periods implied by these churn rates, indicating that large and small consumers effectively contract for similar periods[3]
4. Large end users have found that small retailers have little appetite for contracting with them to supply electricity as the risk of a single large load in a small retailer's portfolio increases the retailer's risk, so to assume that smaller retailer will start contracting with large end users because of the introduction of the reliability obligation (and thereby increase competition) is fanciful.

The arguments that supposedly support transferring the reliability obligation to large end users does not stand up to scrutiny, but what they do is to increase the costs for large end users for no benefit. What is more, this obligation will increase the numbers of qualifying contract seekers from the same number of providers that deliver electricity from an energy-only market which is already considered to be highly concentrated, resulting in the providers being able to increase prices due to the demand from more seekers.

As the MEU pointed out in its response to the draft design consultation paper, almost all end users of gas have a variable demand and the MEU provided the following chart of one of its member's annual usage pattern[4].

[2] For example, see AEMO monthly retail transfer statistic June 2018
[3] The MEU notes that large end users would like to contract longer as this provides a more stable cost structure, but retailers offer longer pricing at higher rates that implied by the futures market due to higher risks
[4] This MEU member's electricity demand lies well above the proposed 5 MW threshold



Source: MEU member usage data

What this highlights is that demand varies considerably over time and this is for a variety of reasons, such as for the variation in electricity needs between different products, maintenance requirements and the period between changes to different products. The implication of this variability of demand is that for a large end user, it would have to contract for firm reliability for its peak demand despite its regular demand being perhaps 75-80% of its peak demand.

This concern is compounded by the fact that a single site does not have the ability to reflect the diversity that multiple loads provide. Within a retailer's portfolio, they have many large users whose peak demands are not coincident. This diversity of demand across a number of large users results in a coincident peak demand much lower than the addition of all individual peak demands for all of the end users > 5 MW. In his presentation to the ESB on 1 July 2018, Mr Brian Morris of Schneider indicated that the impact of this undiversified peak demand might well be a premium of some 50% above the diversified demand for these loads. In contrast, retailers benefit from their ability to aggregate load to maximise the benefits of diversification – after all, this is a core benefit of retailer activity.

This loss of diversification results in two significant issues.

1. If an end user is contracting effectively for 50% more reliable supply than is actually needed, then this will reduce the available supply of reliability products and unnecessarily increase investment in additional amounts of reliable supply that is not required for a well functioning market. This effectively increases costs in the NEM for no benefit.
2. If each end user >5 MW contracts for 50% more reliable supply than is needed, this will add an unnecessary cost premium for the acquisition of the supplies of reliability products. This increases costs incurred by end users >5 MW and makes them less competitive in their markets for no reason.

The detailed design requires liable entities to develop a suite of reliable supplies to manage their risk, moderated by the relative "firmness" of each source to provide sufficient reliable supplies to manage 100% of their reliability requirements from dispatch periods of 5 minutes[5] to many hours over multiple days.

While retailers already have to address the varying firmness of energy supply contracts to match the needs of their customers, extending this existing process to encompass supplies of reliability products is a natural progression and readily accommodated within a retailer's existing processes. In contrast, imposing the reliability requirement on end users >5 MW introduces an entirely new requirement for them which has nothing to do with the issues they face in their own markets. Noting that this requirement might only occur occasionally, they will still have to be prepared in the event that the obligation becomes imposed. This will result in considerable costs for them and make them less competitive in their own markets, just so that the electricity market might function a little more efficiently. While retailers' core business is to manage these functions (especially allocating firmness of supply to various forms of generation), it is not the core business of end users of electricity who have concerns in their own markets which they must focus their attention on.

The MEU points out that to impose a requirement on end users to assess the firmness of the various forms of generation supply does not recognise that end users have no experience in this quite specialised process. An underlying concept of the NEM rules is that responsibility for managing issues is to allocate the risk to those best able to manage the risk. End users do not have the knowledge or experience in allocating "firmness factors" to different forms of generation or even to individual generation plants.

For example, the MEU is aware that Bayswater power station is probably more reliable than Liddell power station, yet an end user new to the market has no knowledge as to the degree of the firmness of the generation offered by each. Such similar considerations apply to other forms of generation as well as between different forms of similar generation. In contrast, this information and experience of performance is a "bread and butter" activity for retailers.

Another example about firmness of qualifying contracts relates to the use of inter-regional flows. The MEU notes that in assessing the materiality of the reliability "gap", AEMO will "reflect the inter-regional transfer capability between regions". Yet in determining the firmness of qualifying contracts, unless a liable entity has a covered position on the interconnector through holding SRA units, a qualifying contract will be classified as "low firmness" despite AEMO using its full capability in assessing the gap. As SRA units are held mostly by retailers as a tool for continuously managing their energy supply risk in a regional market, SRA units will generally be not available to liable end users reducing their ability to obtain competitive offers for the reliability cover, effectively raising their costs.

[5] Noting that 5 minute settlement will be introduced from 1 July 2021

The MEU highlights that large end users (eg steel, paper or cement makers) do not require the NEM Participants to understand and contribute to the reliable supply of their products yet the electricity market is requiring exactly this of end users of electricity.

While the MEU does recognise that there is a need to ensure there is sufficient reliability in the electricity market, it should not be an imposition placed on large end users who have little knowledge of the market, who will have to incur significant costs to comply with the new requirements (for no benefit to them) and, due to a lack of diversity, will have to contract more reliable supply than they, as a group, really require.

With these thoughts in mind, the MEU considers that the detailed design process needs to be modified to reflect:

- The reliability obligation should be limited to Market Participants who have elected to be active in the electricity market and not be extended to end users who have elected not to be market participants for very sound reasons
- End users should be able to opt in to the reliability of supply process if they wish to rather than being obligated.

3.2 Qualifying contracts

As noted in section 3.1, the MEU considers that the process for establishing qualifying contracts is a complex matter that is particularly challenging for large end users that will have to implement actions about which they have little knowledge or experience and will have to do so only occasionally. The MEU points out that the more complex a matter is, the greater the risks and therefore the greater cost to manage those risks; large end users are not best able to manage these electricity market risks.

The technical working paper on qualifying contracts includes a significant array of options which can be used to meet the reliability requirement. To achieve the maximum benefit from these options is not a straight forward task. Such an activity should be allocated to those parties who have the requisite skills and experience such as a retailer rather than to an end user that might only need these occasionally.

A default position for large end users will be to either contract with retailers for reliable supply or to contract with dispatchable generators which will limit their ability to access lower cost generation when there is no reliability issue forecast. The MEU considers that unless a large end user is a Market Participant or elects to opt in, the default position should be that its retailer has to carry the reliability obligation just as they do for smaller end users.

The MEU also notes that the ESB proposes that large end users that are liable entities and have supply arrangements already in place should have these prior arrangements “grandfathered” providing they were in place before 20 April 2018. The MEU points out that the concept of grandfathering was not mentioned as part of the high level design. The MEU considers that grandfathering should apply from the time large end users became aware that they would be liable; that is from the release of the detailed design consultation paper on 15 June 2018.

3.3 The market liquidity obligation

As highlighted in the ACCC report on their retail electricity market enquiry, the three dominant vertically integrated generator/retailers ("gentailers") either own directly or control a large proportion of the available dispatchable generation in all regions other than Queensland and Tasmania where generation and significant retailing activity is state government owned. The market liquidity obligation (MLO) has been introduced to limit the ability of these gentailers to exercise market power and to support some competition in the provision of "reliability products".

The MLO does not reflect the reality of internal transfer pricing. A vertically integrated firm is agnostic as to where it makes its profits. As is being seen in the NEM now, large low short run marginal cost (SMRC) generators are benefiting from a market with low competition to increase the costs of their output. For example, brown coal fired generators have a SMRC as low as $10-$15/MWh[6] yet they are selling their output at many multiples of this. If there were sufficient competition, then generators would sell their output at levels closer to their SMRC as was envisaged when the NEM was initially developed.

Under the NEG, there is nothing to prevent the gentailers selling the reliability products to their related retailers at high prices and for the gentailer to take its profits within their generation division. The only way that the gentailers will sell their reliability products at price close to their cost is if there is strong competition from others outside the gentailer firm. As the ACCC has advised in their report on the retail electricity market, there is too little competition to ensure energy prices are as low as possible, let alone the price of reliability products.

With low competition, the concepts proposed underpinning the MLO do nothing to prevent the gentailer's generator selling its reliability products to its associated retailer at a high price even if there is a limit on bid and offer spreads and a requirement to trade on a centrally cleared platform. While the MLO proposals do provide transparency and some liquidity, the prices can be set very high due to low competition.

The MEU remains unconvinced that the MLO will ensure that prices for providing the reliability obligation will be efficient and counter the market power resulting from structural concentration of large gentailers in each region.

3.4 Demand side responsiveness

In principle, the MEU considers that end users just want to have electricity so they can address the needs of the markets they operate in, rather than attempting to make the electricity market more efficient. However, the MEU also knows that, in attempts to minimise their electricity costs, end users do use the ability to reduce demand when the value of them of doing so exceeds the cost of implementing the load reduction.

[6] See consultant reports to AEMO advising about different generator pricing structures

The MEU considers that demand response (DR) can be a low cost option for the NEM and therefore supports DR qualifying under the reliability requirement. However, the arrangements for providing DR under the rules lie with the provider either contracting with its retailer or with AEMO under the RERT. This limits the ability of the DR provider maximising the value of its DR and so limits the provision of DR.

The MEU is of the view that to maximise the availability of DR, the rules need to allow third party DR aggregators to operate in the market. This allows DR providers a wider range of potential buyers of their services, increasing their value. The MEU points out that there are currently only modest amounts of DR provided to the market and this is a direct outcome of requiring DR providers to only contract with their retailers. This puts retailers in a very strong position to limit the value of the DR. While the reliability requirement might increase retailers' appetite for DR, it still constrains end users from maximising the value of the DR available.

Allowing third party DR aggregators to operate in the NEM addresses a number of drawbacks associated with providing DR. For example, DR is only available if the provider is actually using that amount of electricity at the time the demand reduction is called and a DR provider might have other obligations from their own markets to fulfil and so cannot make the DR available when called. Implementing the ability for DR aggregators to enter the market allows the aggregator to incorporate diversity of supply to address the potential inability of every DR provider to be able to fully comply at any one time. A DR aggregator will assemble a portfolio of DR offers and be able to provide firm contracts to liable entities.

Unless DR aggregators are permitted in the rules to operate in the market, the MEU is very concerned that the availability of DR for the reliability requirement will not be as extensive as is expected, or required, to minimise the cost of the reliability obligations.

3.5 Materiality of the trigger

The proposal recommends that the forecast by AEMO that there is a "gap" in reliability needs to be material before the trigger is enacted, but the proposal does not define what is considered to be material; it would appear that the materiality will be set at a later stage by AEMO, presumably after consultation as AEMO establishes its procedures.

The MEU considers that this approach is flawed. The gap is defined in terms of unserved energy in a regions which, while there is a target of less than 0.002% of unserved energy in each region, this value is to be attained over the longer term implying that sometimes Reliability Standard might be exceeded. The MEU considers that materiality is a policy issue rather than an issue to be left up to the decision of the market operator. While the MEU agrees that "hard wiring" of an absolute value for the "materiality" of the forecast gap is not the best approach, it does consider that there is a need for guidance to be provided in terms of qualitative measures.

This is important as there is likely to be significant investment resulting from the forecasting of a gap and if the actual demand is less than forecast such that reliability

would not otherwise have been an issue, this might result in considerable expenditure for no reason.

It must be recognised that historically AEMO has tended to over forecast future demand than under forecast it so, on average, the gap is more likely to be overstated than understated; this is risk potentially further exacerbated in that AEMO runs a series of different scenarios to develop its average outcome. With this in mind, a qualitative measure might be that the gap has to be defined as a range, and that a certain number of standard deviations are set to ensure that there is a high likelihood of there being a gap.

3.6 The SA government proposal

The South Australian government has proposed a modification that would eliminate the exercise of the trigger at the three year point of the reliability obligation process (ie T-3) and require participants to monitor the market so that they are aware that AEMO is forecasting a shortage in particular year and that it will trigger a gap at T-1. The import of this change is that there would be an enduring obligation rather than one set when needed.

The MEU points out that there is no analysis provided with the SA government proposal so this lack makes if difficult to assess whether the option has any benefit over the proposed arrangement. On balance, the MEU cannot see there is any benefit but it can see there is significant detriment.

The purpose of the trigger at T-3 is to allow sufficient time for liable entities to implement their reliability obligations with the knowledge that such an obligation exists. While the market has, over the years, implemented investment in sufficient time to consistently deliver the Reliability Standard in each region, there has been no explicit enforced obligation to back this up with penalties. To enforce an obligation without clarity that an obligation existed prior to the imposition of penalties is unreasonable.

With this in mind, the MEU supports retention of the three year forward notice to impose the obligation. To impose an enduring obligation as proposed by the SA government is likely to increase costs in the market for little benefit. The value of the three year notice period is three fold:

Firstly it identifies there will be an obligation, that there is a two year time frame to implement investment needed to manage that obligation and to report the obligation has been fulfilled to the AER by T-1. To eliminate the trigger date increases risks for Market Participants and large end users that there is likely to be insufficient time to implement the lowest cost options to address the forecast shortage. Already AEMO has identified that they would prefer more time to implement their Reliability and Emergency Reserve Trader (RERT) process from the current 9 month period just recently implemented. To expect other stakeholders to implement in less time the same processes that AEMO will undertake is unrealistic. Further, the RERT process is intended to be implemented only if there is not sufficient reliable supply in the year when the shortage is identified. AEMO needs to be able to assess if there is going to be sufficient reliable supply before it implements its RERT process. As AEMO already

has advised, it will need more than 9 months for the RERT, so stakeholders need to be well down the path of implementation of their processes before AEMO commences theirs.

Secondly, AEMO has identified that the lowest cost option for the market requires an ability to contract longer than just for one year when they are looking to implement the RERT. To limit taking action just one year out, will not result in the lowest cost option. This means that there needs to be more time provided to allow stakeholders the ability to identify the lowest cost options and having a two year notice period allows this to occur.

Thirdly, the MEU notes that if a reliability shortage is triggered, stakeholders will need sufficient time to identify the most appropriate option, design it and then complete a build and commission process. If the assessment results in the construction of a new dispatchable generation plant, an overall 2-3 year time frame is likely to be needed to have the new plant available before the forecast time of the shortage occurs. While it is possible that such plant might be available to add output to the market in a shorter time, this could result in higher costs.

The NEO requires that changes need to be the most efficient (ie lowest cost) option so to unnecessarily limit the time to investigate and implement the lowest cost option does not comply with the NEO.

On balance, the MEU considers that the three year notice is a pragmatic and sensible option.

3.7 Penalties

The MEU is very concerned that the ESB proposes there be double penalties applied to non-compliant liable entities. In addition to incurring a share of the RERT costs, it is proposed that liable entities will also receive non-compliance penalties which could be as high as $100 million.

The MEU considers that the penalties for not holding sufficient qualifying contracts should not exceed a proportionate share of the RERT costs, as this is the cost that the market incurs as a result of the non-compliance.

The MEU considers that a liable entity's lowest cost option might be to accept its share of the RERT costs. This approach is consistent with the penalties associated under the Renewable Energy Target where the maximum liability is factored in relation to the cost to provide the requisite number of certificates with no additional penalty being applied. .

The potential of "double jeopardy" is inconsistent with other fundamental cost sharing approaches embedded in the NEM rules where costs have been consistently applied on a "causer pays" basis without compliance penalties added.

However, where a liable entity is non-compliant in areas not related to incurring the costs of the RERT such as not complying with the Market Liquidity Obligation, the MEU accepts that there is a need for non-compliance penalties.

3.8 AEMO book build

The MEU notes that the ESB is only "considering" the implementation of a voluntary book build approach to assist in liable entities being able to source reliability contracts from the market. The ESB seems to consider that a book build is not needed if there is a Market Liquidity Obligation implemented.

If the ESB persists with making end users >5 MW liable entities, the implementation of a book build becomes essential so that these large end users have ready access to qualifying contracts to fulfil their obligations. It needs to be remembered that getting qualifying reliability contracts is not end user's core business and so they will need assistance for them to be able to comply. A book build developed by AEMO will make it possible for end users to more readily comply.

However, despite there being a book build available, it must be pointed out that this will still exposes large end users to increased costs or the lack of diversity and ability to assess "firmness" noted in section 3.1 above.

3.9 Licences

The MEU notes that currently market participants the NEM are exempt from requiring them to hold a Financial Services Licence (FSL). It is not clear whether introducing the NEG will result in the requirement for a FSL. This is particularly important to MEU members as they currently do not require such licences.

The MEU considers the NEG process should be exempt from the financial services licence requirements.

4. Conclusions

While some steps have been made to limit the reduction of competition with the emissions leg of the NEG, the MEU considers there are still aspects of the design which result in there being less competition in the reliability leg which, when combined with the significant complexity to manage the process, will result in the pass through of higher costs for consumers.

The decision to make end users with > 5 MW demand liable entities for the reliability leg will result in higher costs for these consumers but with little overall benefit, especially as these customers will be over-contracting to match non-coincident demands. As they also will be in the market for qualifying contracts along with retailers, this will result in more reliability contract seekers from the same number of providers, leading to an increase in price for qualifying contracts. The MEU considers that the already low competition extant in the NEM will allow dispatchable generators to maximise their prices for a service that should be available at a very low cost.

What consumers need are changes that increase competition, not reduce it and while there are some improvements to minimise the further loss of competition that the NEG

will impose on the market, the question still remains, will the NEG really deliver anything other than “do no harm”?

The MEU considers that the increase in complexity, loss of transparency and wide reaching exposure of larger end users to the reliability leg leads to a circumstance that there consumers will be harmed. This means that the NEG detailed design needs to better address the issues of loss of competition and transparency, and increased complexity

The MEU is happy to discuss the issues further with you if needed or if you feel that any expansion on the above comments is necessary. If so, please contact the undersigned at davidheadberry@bigpond.com or (03) 5962 3225

Yours faithfully

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