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Energy Security Board

Sent by email: info@esb.org.au

Sumo Response to Draft Detailed Design Consultation Paper

Sumo welcomes the opportunity to respond to the Energy Security Board's National Energy Guarantee Draft Detailed Design Consultation Paper dated 15 June 2018 (**Consultation Paper**).

Sumo is a small, fast-growing utility provider, with around 50,000 residential and small business electricity and gas customers in Victoria. It is a stand-alone retailer, with no physical generation assets.

Sumo's position and summary of recommendations

In Sumo's view, the proposed National Energy Guarantee (**NEG**) will increase costs and risks in the energy industry, which costs will ultimately be borne by energy consumers. Those risks will be most significant for non-vertically integrated retailers, and so the NEG will necessarily advantage those with generation assets. If this results in further consolidation of the industry, it will lead to a lessening of competition which in turn will also drive higher prices and less innovation.

Further, we note that industry consultation has been conducted at great haste, exacerbated by the desire to present a final NEG design to the COAG Energy Council at its August 2018 meeting. This process provides little (if any) ability to properly respond and reconsider the fundamental aspects of the design.

The emissions reduction target is complicated by the fact that it places a direct compliance obligation on a retailer or large customer to meet emissions intensity targets on behalf of generators. This is quite different from the existing renewable energy target, which creates a transparent trading market for certificates that represent renewable generation.

The key risk for non-vertically integrated retailers is that they will be unable to procure sufficient allocations of low-emissions generation for the purposes of meeting the emissions reduction target, or will only be able to do so at prices above commercial rates.

Retail competition has been shown to be hindered by lack of competition in the wholesale market. This is because (a) there are not many electricity generators in the market, and (b) many generators are in fact owned by retailers. Placing the emissions reduction requirement on generators rather than retailers would level the playing field for retailers and could overcome the above concerns for non-vertically integrated retailers.

Alternatively, a liquid and transparent certificate scheme, such as exists for the renewable energy target, would assist non-vertically integrated retailers to meet the obligation at a fair and transparent cost. Or exemptions could apply for retailers without an ownership of generation.

Industry concerns about lack of wholesale market transparency and liquidity need more consideration. We note that the ACCC has made some recommendations in this regard.

Notwithstanding our grave concerns, assuming the NEG is designed broadly as set out in the Consultation Paper, we also set out below some further observations and recommendations:

Emission reduction requirement

#	Recommendations
1	*Penalty regime* – In order to minimise costs to end-use consumers, the penalty for non-compliance should be both certain and proportionate. It is recommended that the maximum penalty be significantly reduced, and that the penalty regime comprise a fixed penalty per unit of underachievement in excess of the deferral limit, which would facilitate efficient transfers of lower emissions generation allocation and allow liable entities to manage the pricing risk.
2	*Flexible compliance options* – Further consideration should be given to mechanisms to protect non-vertically integrated retailers in circumstances where the emissions reduction target for the whole market is met, but where access to low-emissions generation allocation is limited due to other liable entities carrying forward their over-achievement.

Reliability requirement

#	Recommendations
3	*Timing of submitting qualifying contract position* – It should be sufficient for a liable entity to provide their hedge position to the AER soon after the applicable gap period, or at most a month ahead.

Emissions reduction requirement

As above, Sumo considers that the emissions reduction mechanism presents particular risks to retailers that do not have ownership in low-emissions generation.

Penalty regime

Sumo supports the use of penalties as a tool to enforce compliance. However, the penalty regime proposed in the Consultation Paper is both disproportionate and uncertain.

- Disproportionate and excessive

  The proposed maximum civil penalty of $100 million for exceedance of the deferral limit, or for over-allocation of generation to the liable entity's load, is excessive. The penalty should be proportionate to the size of the liable entity and the level of non-compliance. The imposition of a $100 million penalty would be catastrophic for many liable entities, like Sumo. The penalty may be particularly unfair and onerous in circumstances where a liable entity has fallen short despite using best efforts to comply. For instance, a liable entity could feasibly fall short of the deferral limit, or might over-allocate generation, either due to forecasting errors, or because of a shortage of counterparties that are willing to allocate or receive a reallocation of low emissions generation, or due to a combination of both. This may be the case even

where the market as a whole achieves the emissions reduction target, as discussed further below.

- Uncertain

  Compliance with the emissions reduction requirement appears to be framed as an absolute obligation. As an absolute compliance obligation, liable entities would arguably be expected to achieve compliance no matter what the cost. On the other hand, the penalty for non-compliance is unknown. Given the discretion afforded to the AER in enforcing compliance, the penalty could be as much as $100 million, or it could be zero.

  In these circumstances, negotiations for the transfer of generation allocation will be conducted in an environment that lacks transparency, leading to inefficient outcomes. Liable entities that do not own low-emissions generation will be in a weak negotiating position and, faced with the prospect of potentially excessive penalties for non-compliance, may be forced to pay significantly more than others to achieve compliance.

  One way that a retailer manages the risk of cost increases is to factor them into its retail prices. A retailer faced with significant uncertainty in cost will necessarily need to make greater allowance for that cost. An inefficient market for allocation of generation could therefore lead to unnecessary increase in consumer electricity prices.

  The penalty regime should be transparent so as to facilitate fair and efficient compliance. In order to facilitate market transparency and lower the cost of compliance for all participants, it would be appropriate to set a fixed penalty price in respect of a compliance year based on level of under-achievement.

In order to minimise costs to end-use consumers, the penalty for non-compliance should be both certain and proportionate. It is recommended that the maximum penalty be significantly reduced, and that the penalty regime comprise a fixed penalty per unit of underachievement in excess of the deferral limit, which would facilitate efficient transfers of lower emissions generation allocation and allow liable entities to manage the pricing risk.

Flexible compliance options

The Consultation Paper describes flexible options for compliance with the emissions reduction requirement, permitting liable entities to carry forward over-achievement or defer under-achievement. Sumo supports this mechanism. Flexibility is necessary because liable entities will always be subject to a degree of inherent forecasting error. It would not be efficient to require market participants to trade very small amounts of generation allocation after the compliance year has ended in order to true up their position simply to account for reasonable forecasting errors.

It is necessary to limit the amount of over-achievement able to be carried forward for each liable entity, to prevent a large market participant from squeezing the market and limiting other participants access to low-emissions generation allocation (particularly participants with no generation or limited financial capacity). The carry forward limit should be set at a level that accounts for a reasonable level of demand forecasting error, while at the same time protecting the interests of participants that do not already have an interest in low emissions generation.

Whatever the carry forward limit is, one specific concern Sumo has is that a liable entity could fail to achieve its emissions reduction requirement, despite best efforts, and even when the market as a whole has achieved the target. This could happen where larger participants have chosen (in good faith) to carry forward an amount of over-achievement within the carry forward limit. Although under the draft design liable entities can defer non-compliance up to 10% of the target, this could well be inadequate to address the concern – in absolute terms, the 5% over-achievement by a large market participant will be significantly more than the 10% under-achievement by a smaller participant. In these circumstances, a significant penalty would be grossly unfair.

Accordingly, further consideration should be given to mechanisms to protect non-vertically integrated retailers in circumstances where the emissions reduction target for the whole market is met, but where access to low-emissions generation allocation is limited due to other liable entities carrying forward their over-achievement. One option might be that the deferral limit in that compliance year for liable entities is increased in absolute terms to the extent that other participants have carried forward over-achievement. In simple terms, where some retailers have carried forward an aggregate of, say, 100 units of over-achievement, other retailers would be permitted to defer up to 100 units in aggregate.

NEG Reliability Requirement

As with the emissions reduction requirement, Sumo considers that the reliability requirement presents particular risks to retailers that are not vertically integrated with a generation asset. Having said this, one positive aspect of the draft NEG design is that it relies on the existing financial derivatives market and so limits its impacts on the existing market design.

Qualification framework

The proposed approach for qualifying contracts – that any wholesale contract with direct links to the electricity market which a liable entity uses to reduce exposure to high spot prices should qualify – is sensible. It will also be important to ensure demand response will qualify, as proposed.

The design appears to require retailers to submit their contract position to the AER a year before the forecast gap. It is not clear why this needs to be the case. Retailers will ordinarily continue to hedge their load less than 12 months before a relevant period, to spread pricing risk and to account for movements in forecast load. It should be sufficient for retailers to provide their hedge position to the AER soon after the applicable gap period, or at most a month ahead.

If you would like to discuss any aspect of this submission, please contact me or Alex Fleming, GM – Legal & Regulatory.

Yours faithfully

Paul Cullinan
Managing Director & CEO