

14 March 2018

Energy Security Board

By email: [info@esb.org.au](mailto:info@esb.org.au)

**National Energy Guarantee (NEG) Draft Design Consultation Paper (Consultation Paper)**

Sumo welcomes the opportunity to respond to the Energy Security Board's Consultation Paper.

**Background and overview**

Sumo entered the Victorian energy retail market in 2015 and has grown to close to 40,000 residential and small business energy customers. It does not own generation assets. As a small, stand-alone retailer, Sumo has a unique perspective on the impact of the NEG and the considerations that should affect its design.

Sumo is supportive of initiatives that will help Australia meet its emissions targets, and that will ensure the energy system continues to deliver reliable supply, at lowest cost.

However, Sumo does not support the design of the NEG as it is currently proposed.

To achieve a lowest cost outcome, Sumo considers that the NEG must be designed such that:

- (a) it minimises market disruption – any impacts on the current market are minimised to the greatest extent possible. Changes (however small) to market design can have unintended consequences and impose considerable additional cost. These costs will ultimately be passed on to consumers; and
- (b) competition in retail and wholesale markets is enhanced – any changes that are likely to drive further consolidation of vertically integrated market participants will further degrade competition, resulting in higher prices for consumers.

The existing market has worked well to date in achieving emissions targets and delivering a reliable supply of electricity. We need to ensure that the market is capable of maintaining reliability standards and emissions targets into the future. The design of the NEG must ensure these outcomes continue, but without increasing costs.

Importantly, the NEG should not impose emissions and reliability obligations directly on retailers. Retailers have never played a role in physical supply and are not well equipped to do so. Rather, any reliability and emissions requirements under the NEG should be imposed on generators.

**Summary of recommendations**

A summary of our key recommendations follow:

#	Market dynamic
1	The NEG should impose reliability and emissions obligations on generators – not retailers – as generators are best equipped to meet those obligations.
2(a)	If the NEG does impose reliability and emissions obligations on retailers, it should impose those obligations on larger, vertically integrated retailers. Smaller, stand-alone retailers should be exempt on the basis that the cost impact on them will be disproportionately high and their impact on achieving reliability and emissions outcomes will be negligible.
2(b)	If the NEG does impose reliability and emissions obligations on smaller retailers, then certain financial hedges (such as swaps) should be deemed to meet reliability and

	emissions requirement. In particular, load-following swaps are almost certainly backed by dispatchable, reliable generation, and should be preserved to support smaller retailers.
3	The NEG should aim to increase liquidity in wholesale electricity markets and increase retail competition, rather than threaten financial hedging markets and encourage greater consolidation of existing vertically integrated gentailers (as the currently design is likely to achieve).

### The existing market works well

As currently designed, the National Electricity Market does not require retailers to participate in the *physical* electricity supply market as they are not best equipped to do so. Physical security and supply is managed very effectively by AEMO and generators. Rather, retailers can manage wholesale risks by engaging in the *financial* hedging market.

While Sumo has concerns with ongoing liquidity in financial hedging markets, generally these markets are mature and have proven to be effective in enabling retailers to manage wholesale risk. Importantly, new retailers can enter the electricity retail market without procuring physical supply and, provided there is sufficient liquidity in financial markets, the barriers to entry into the retail market are (relatively) low.

It is therefore critical that the design of the NEG seeks to increase liquidity in financial hedging markets, not reduce it.

To date, the NEM has worked well to deliver a reliable electricity supply.

- Despite the closure of some baseload electricity supply (e.g. Hazelwood) and a trend towards more intermittent solar and wind-powered generation supply, the market has continued to deliver a secure and reliable supply of electricity. AEMO has proved very adept at managing the physical market, and the current market mechanisms for managing reliability are working.
- Where AEMO projects a shortfall in supply, the Reliability and Emergency Reserve Trader (RERT) mechanism enables it to contract for electricity reserves (generation and demand response). AEMO called on its RERT powers twice this summer with success.
- The introduction of 5-minute settlements will also help enhance reliability by inviting additional fast-start capacity into the market.
- An effective and low-cost approach to implementing a reliability guarantee under the NEG would be to seek to enhance the existing RERT mechanism. For instance, improvements in transparency would enable all retailers to assess their potential exposure to the RERT, source alternate hedging cover for RERT exposures and participate in RERT contracting.

The market has had an effective means of achieving emissions targets.

While it has brought challenges, the Renewable Energy Target (**RET**) has successfully delivered the emissions target to 2020.

Alternatives to the RET should only be implemented if they are shown to deliver future emissions targets at lower cost. As discussed further below, Sumo is concerned that the NEG – if it requires retailers to enter into physical supply contracts – is likely to add additional cost and complexity.

One of challenges caused by the RET is that, by championing intermittent, low emissions technologies such as wind and solar, it has put pressure on existing mechanisms for maintaining reliability standards. Instead of replacing the RET, the Energy Security Board might consider ways to enhance the existing RET design to overcome these challenges. For instance, a future renewable energy or emissions target could be combined with a requirement for new eligible generation to also meet minimum reliability / dispatchability standards.

## **The proposed design elements are likely to add cost**

In order to deliver on its reliability and emissions objectives at lowest cost, it is essential that the NEG avoids unnecessary market disruption. Energy markets should not be unnecessarily 'gold plated'. As discussed above, the NEM currently delivers a reliable electricity supply and is meeting its emissions targets. Any changes should be minimalist. (As a separate but related point, our concerns extend to proposals to introduce a day-ahead market.)

Even small changes are likely to drive significant cost and lead to unintended consequences. Any such increases in costs must ultimately be borne by consumers. Costs will arise from:

- Reduced liquidity in hedging markets – A highly competitive and liquid financial hedging market drives down the wholesale cost of electricity. As above, the existing financial hedging market is mature, and enables retailers to manage wholesale risk effectively. Participants in the financial market include generators, but also include intermediaries such as financial institutions who do not own generation assets. Financial hedge providers can pool positions from several sources to provide competitive financial products. This increases liquidity and lowers costs. A requirement on retailers to meet reliability or emissions targets by procuring physical supply will necessarily impact the financial hedging market.
- Physical hedging contracts will be more expensive – If the NEG requires retailers to participate in the physical hedging market, retailers who do not own applicable generation assets will likely need to enter into new, bespoke physical contracts. As each generation source is different, negotiation of such contracts would be more complex, time-consuming and less liquid than existing financial contracts, and would likely transfer additional risks to the retailer (such as the risk of generator outage) or otherwise come with higher risk premiums. Retailers will require more wholesale resources to manage this process.
- Overhaul of market systems and processes – Any changes to market systems and processes will take time and come at a cost to all market participants.
- Increased compliance costs – Any requirement to ensure hedging contracts meet compliance requirements, and to report to a regulator, will impose cost.

These costs are likely to have a disproportionate impact on smaller, vertically integrated retailers. These retailers are more likely to rely exclusively on financial hedging markets today, and so will need to build resources and expertise to meet the new requirements. Any costs incurred by smaller retailers will necessarily be spread over a smaller number of customers.

*In our view, the NEG should not impose emissions and reliability obligations on retailers. Retailers have never played a role in physical supply and are not well equipped to do so. Rather, any reliability and emissions requirements under the NEG should be imposed on generators. Any attempt to design a market that enables retailers to meet such an obligation will add complexity and cost.*

*If the NEG does introduce a physical hedging requirement (and we don't think it should), then:*

- *it should only apply to large, vertically integrated retailers – these retailers are best equipped to manage the obligation, and will have the greatest impact on reliability and emissions targets; and*
- *if it does apply to smaller, non-vertically integrated retailers, then certain financial hedges (such as swaps) should be deemed to meet the reliability requirement. In particular, load-following swaps are almost certainly backed by dispatchable, reliable generation. Some smaller retailers rely on load-following hedges because they are considered the most effective way to manage wholesale risk.*

## **The NEG must not have a detrimental impact on competition in retail and wholesale markets**

Competitive retail and wholesale markets are essential for pushing down prices to end consumers and driving innovation.

Currently, there are next to no stand-alone generators in the market. If the NEG requires retailers to take a physical supply position, then in most instances, stand-alone retailers will be forced to contract with their vertically integrated competitors. It is likely that this will mean such stand-alone retailers will not be offered the most competitive price, and that generators will seek to pass through much of the physical risk.

By requiring retailers to meet physical reliability standards and emissions targets, the NEG would therefore encourage retailers to acquire physical supply assets. The NEG would push the market towards more vertical integration, which will further consolidate wholesale and retail markets and reduce competition in both. Smaller retailers who cannot secure reliable and low emissions generation of their own would likely be forced out of the market. Market consolidation of this kind and the resulting impact on competition is likely to lead to higher prices for consumers.

*Rather than allowing this to happen, the NEG should aim to increase liquidity in wholesale electricity markets and increase retail competition. Effectively operating and competitive markets will provide the support needed for investment in reliable, low emissions solutions.*

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

Yours faithfully



Paul Cullinan  
**MD & CEO**