Review of Energy Market Frameworks in light of Climate Change Policies

AGL Response to Interim Paper

Executive Summary

AGL welcomes the Review being conducted by the Commission and agrees with the Commission's view that there are limited regulatory changes needed in order to prepare the market for the introduction of the CPRS. The Australian energy market will naturally move to adjust to a carbon constrained economy and therefore any excessive regulatory intervention should be avoided.

AGL is party to a number of joint submissions: The Clean Energy Council, National Generator Forum, Energy Retailers Association of Australia and a group of Victorian generators. We fully support those submissions but would like to separately draw the Commission's attention to a couple of specific issues.

AGL believes the primary focus of any regulatory change should be to ensure there is sufficient incentive for market participants to make the necessary investments in assets and infrastructure. Accordingly, the two key issues the Commission should focus on are:

- the appropriate mechanisms to ensure retailers are able to pass through the full costs of the CPRS and associated policies; and
- appropriate access, including protection of that access for generators.

Carbon and MRET cost pass through

The most critical issue for retailers, and the market more broadly, is the ability of retailers to pass through the costs associated with the changes to government policy. As the Commission has clearly recognised, the continuing jurisdictional regulation of retail prices presents a very real threat to retailers' ability to fully recover their costs. AGL notes that without full cost pass through:

- the investment in the market that will be necessary to drive the transition to a carbon constrained economy will be at risk, as retailers will not be in a financial position to invest, or underwrite investment, in the market.
- the objectives of the CPRS will be undermined by inefficient price signals being passed through to end use customers; and
- retailers will not be able to absorb the additional costs, and may exit the market suddenly, increasing the potential for a Retailer of Last Resort (ROLR) event.

Generator access

The other significant issue for the market is generator access rules. The application of these rules should ensure that:

- any generator can reasonably connect to the grid at the level of power output they require; and
- once connected, they can achieve the levels of output they expected when they decide to construct their assets. This means preventing later generators removing their access without agreement or compensation.

Accordingly, AGL encourages the Commission to focus on facilitating a framework which ensures:

- full pass through of carbon and expanded MRET costs by retailers (Issue A7). AGL, along with the ERAA and ESAA, advocates the de-regulation of retail prices, or at least the de-regulation of the carbon uplift component. In the absence of de-regulation, AGL advocates co-ordination and development of a set of principles which will guide the approach and methodologies to post-CPRS price regulation;

- that generator access rules minimise the risk of generators being constrained away from the regional reference price without agreement or compensation (Issue A6); and

- connection of new assets is appropriately facilitated where inefficiency in development is likely. This must be confined to specific areas and for major changes in generation technologies. Again, this needs to include protection of the access that is agreed since otherwise the facilitated access is pointless. AGL is of the view that the appropriate regulatory changes to address this issue should be minimised. (Issue A5)

1. Introduction

AGL Energy (***AGL***) is Australia's leading energy company. We operate across the supply chain and have investments in energy retailing, coal-fired electricity generation, gas-fired electricity generation, a variety of renewable generators and upstream gas extraction. The diversity of this portfolio has allowed AGL to develop a detailed understanding of emissions reduction opportunities.

AGL is Australia's largest retailer of gas and electricity with approximately 3.2 million customer accounts in New South Wales, Victoria, South Australia and Queensland. AGL has significant investments in upstream energy markets. We own and operate 645 MW of hydroelectric power generation assets, the 1280 MW Torrens Island Power Station and the Somerton gas-fired power station. AGL also has a 32.5% equity investment in the Loy Yang A power station. AGL operates the 91MW Wattle Point Wind Farm and recently opened the 95 MW Hallett wind farm in South Australia, which is the first stage in what will eventually be one of the largest wind farms in Australia.

AGL is developing a number of new energy assets. It is important to note that all of these assets are consistent with a carbon constrained future. The assets in development include Stage 2, 3 and 4 of Hallett wind farm (71MW, 90MW and 189 MW respectively), Bogong hydro power generator (140 MW), Victorian wind farm sites (Macarthur 330 MW), Leaf's Gully gas fired-power station (350MW), SE Qld gas fired-power station (350MW), Kogan gas fired-power station (350-800MW), and North Qld gas-fired power station (350 MW).

2. Retail cost pass through (Issue A7)

AGL shares the Commission's concern about the lack of flexibility in the current pricing regimes to allow retailers to pass though carbon costs.

As a matter of priority, the Commission should focus its attention on ensuring that retailers are able to fully recover CPRS and expanded MRET costs under the current state based regulated pricing regimes. Without full cost recovery:

- Investment in the market will be at risk as retailers will not be in a financial position to invest, or underwrite investment in the market. This is a significant issue given that historically retailers have underwritten the majority of investment in upstream supply, either through vertical integration or by way of 'foundation' supply contracts. Detailed in **Annexure 1** is a list of the upstream projects that AGL has effectively funded, and some major projects that have been funded by other retailers.

- The objectives of the CPRS will be undermined by inefficient price signals being passed through to end use customers; and

- Retailers may exit the market possibly triggering a RoLR event. At worst, if a sufficiently large retailer causes a RoRL event, it may destabilise the operation of the market.

Determining carbon costs

As identified in AGL's previous submission to this Review, retailers will incur significant increased costs with the introduction of a CPRS and expanded MRET. These increased costs will be comprised of direct compliance costs, increased upstream costs of supply, and transmission and distribution services.

Increased wholesale costs are likely to be the biggest component of any cost / price increase for retailers. Currently there is a lack of transparency about what those costs will be in a carbon constrained economy. This is because, at present, very few if any, generators are offering contract cover to retailers for energy beyond 1 January 2010. Generators appear unwilling to sell forward contracts beyond 2010, with or without a carbon price included, due to the uncertainty around the targets, trajectories and auction design. In addition, AGL believes that the uncertainty around compensation arrangements for carbon intensive generators is having a very significant impact on liquidity.

Further, AGL does not anticipate that the announcement of targets and trajectories will completely alleviate the lack of long term contract liquidity. Ongoing liquidity concerns will be exacerbated if generators are not able to delay the payment for permits – generators will not have the cash resources to acquire permits for outer years, and it seems probable that generators will continue to be reluctant to enter into contracts for energy without having secured the associated CPRS permits.

This poses a number of issues for the market. However, AGL does not advocate a significant regulatory response to these issues, as they will be resolved by the market in due course. The only regulatory response which will ameliorate these liquidity concerns is permitting generators to delay the payment for permits until the date of surrender.

These transitional market issues will create challenges for regulators seeking to determine on a 'forecasting' basis the movement of wholesale energy costs and the impact of carbon on retail prices. AGL encourages the Commission to drive a process with state based regulators and retailers to determine the type of market data required and the process for determining regulated tariffs. The process should include a review mechanism to ensure carbon cost allowances remain in line with forward contract prices, once that market becomes liquid.

3. Generator access rules

Augmenting networks and managing congestion (Issue A6)

AGL considers that avoiding congestion in an economically sound way is essential. We consider that some level of congestion will always occur and, given the intermittent nature of many renewable generators, is probably economically efficient. What is important though is that generators must have security of access so they can reasonably “bank” their projects. This requires that the agreed level of access between a NSP and a generator described in Rules 5.3 and 5.4A is maintained or compensation is provided.

AGL has previously submitted to the Commission’s congestion management review on these issues both individually and with the Southern Generators. In light of the issues raised in the Commission’s Interim Report, the Commission should review the submissions made to that review. AGL is also party to a submission by a group of Victorian Generators that covers this issue in more detail.

In managing congestion, it is important that the correct price signals are given both at the investment and operational levels. This should involve the provision of appropriate locational pricing signals to generators at the time the investment decision is taken, for example the imposition of a penalty on generators who chose to locate in areas that are deemed to already be congested. This is provided, AGL believes, in the Rules:

- A connecting party and the NSP must agree on a level of desired access, which may be less than their plant output;
- The TNSP must make reasonable endeavours to connect at that level, determining all augmentations and modifications to the network to connect the new party while not reducing the quality of access of existing parties;
- The TNSP must negotiate with the connecting party on the Use of System charges to be paid for the access. This amount is taken off the AARR to be recovered from customers;
- The TNSP must negotiate in good faith on payments to be made to a generator if they are constrained off by another generator; and
- The TNSP must negotiate for payments from a connecting generator where they constrain other generators off (which can only occur if they do not pay for the necessary augmentations).

This approach protects the access, and therefore the value, of generators that are already connected to the network. This protection is required whether you are an incumbent to the market or a newly connecting party since financial support cannot be guaranteed where the output of the plant cannot be assured.

In relation to gas markets, many congestion issues have been resolved by participants agreeing to commercially manage the situation. While there is some concern that marked changes in gas use will cause the current arrangements to fail, AGL considers that the Commission should not seek to increase the regulation of gas markets.

Connecting new generators to energy networks (Issue A5)

AGL believes that Options 2 or 3, as stated in the Interim Report, are consistent with our view of the current Rules. The variation relates to the change of circumstances brought about by a change in policy. For this case, AGL considers that it is appropriate that the Rules be varied to allow:

- A central body to determine a location to develop a network hub to support a group of new generators and to extend the network to that hub;
- The central body to determine how many generators are interested and the level of power transfer they will require;
- The full cost of extending the network and augmenting the network to allow the total power transfer capability of the connecting generators plus a determined spare capacity to be charged to the hub;
- The costs of the hub to be charged to the connecting generators in proportion to their use of the hub;
- The power transfer capability of the hub to be allocated on a first come first served basis and charges to generators commence when the capacity is allocated; and
- The unused cost of the hub to be allocated to the beneficiaries of the policy, that is all customers in the NEM.

When the capacity is used up, any new generator should pay the full cost of connection unless the central body determines that the hub should be augmented, in which case the rules for creating the hub apply.

In this way, entry is facilitated but not subsidised.

4. Conclusion

AGL believes there are only limited regulatory changes needed in order to prepare the market for the introduction of the CPRS. AGL encourages the Commission to focus on issues affecting the incentive for market participants to invest in assets and infrastructure. Accordingly, the Commission should ensure:

- full pass through of carbon and expanded MRET costs by retailers. AGL believes this would best be achieved through the de-regulation of retail prices, or at least the de-regulation of the carbon uplift component. In the absence of de-regulation, AGL advocates co-ordination and development of a set of principles which will guide the approach and methodologies to post-CPRS price regulation;

- that generator access rules minimise the risk of generators being constrained away from the regional reference price without agreement or compensation; and

- the connection of new assets is appropriately facilitated where inefficiency in development is likely. This must be confined to specific areas and for major changes in generation technologies. Again, this needs to include protection of the access that is agreed since otherwise the facilitated access is pointless. AGL is of the view that the appropriate regulatory changes to address this issue should be minimised.

Annexure 1

List of Projects

- Somerton - $148m
- Bogong – $234.2m
- Hallett - $140
- Hallett Hill - $166m
- Starfish Hill Windfarm - $65m
- Canunda Windfarm - $92.5m
- Valley Power - $230m
- Playford Power Station Refurbishment - $160m
- Spring Gully/Fairview Coal Seam Methane Projects Qld - $180m
- Sydney Gas – Camden Project - $60m