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Dear Sir/Madam

## **1<sup>st</sup> Interim Report - Review of Energy Market Frameworks in light of Climate Change Policies**

Ergon Energy Corporation Limited (Ergon Energy) appreciates the opportunity provided by the Australian Energy Market Commission (AEMC) to comment on the 1<sup>st</sup> Interim Report – Review of Energy Market Frameworks in light of Climate Change Policies.

The attached submission represents Ergon Energy's response to the AEMC's Scoping Paper.

Ergon Energy looks forward to providing continued assistance to the AEMC in its review of the Energy Market Frameworks.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Tony Pfeiffer', with a horizontal line extending to the right.

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# **Ergon Energy Corporation Limited**

**Review of Energy Market Frameworks in light  
of Climate Change Policies, 1<sup>st</sup> Interim Report  
– Submission**

**Australian Energy Market Commission  
20 February 2009**

# Review of Energy Market Frameworks in light of Climate Change Policies 1<sup>st</sup> Interim Report – Submission

## Australian Energy Market Commission

20 February 2009

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# 1 Introduction

Ergon Energy welcomes the opportunity to make this submission with respect to the release of the 1<sup>st</sup> Interim Report by the Australian Energy Market Commission's (AEMC) on its Review of Energy Market Frameworks in light of Climate Change Policies.

This submission is provided by Ergon Energy in its capacity as:

- an electricity distribution network service provider in Queensland (Ergon Energy Corporation Limited (EECL)); and
- a non-competing electricity retailer in Queensland (Ergon Energy Queensland Pty Ltd (EEQ)).

In this submission, EECL and EEQ are collectively referred to as Ergon Energy.

Ergon Energy has structured this submission in two parts:

**Part 1:** Identifies Ergon Energy's key issues with the 1<sup>st</sup> Interim Report.

**Part 2:** Provides detailed comment on the questions raised in the 1<sup>st</sup> Interim Report.

Ergon Energy would be pleased to discuss this submission with the AEMC and to provide further information should the AEMC require.

## 2 Key issues

### *Distribution Networks*

Ergon Energy is concerned that the AEMC's 1<sup>st</sup> Interim Report does not consider, in any detail, the impact of the Carbon Pollution Reduction Scheme (CPRS) or the expanded Renewable Energy Target (RET) on distribution networks.

It is not clear from the paper whether this is because the AEMC does not consider that distribution networks will be impacted or that its review is not intended to cover distribution networks. In this context, Ergon Energy notes that the Ministerial Council on Energy (MCE) is currently developing a national framework for electricity distribution networks which incorporates network connection, planning and augmentation.

Ergon Energy considers that a statement from the AEMC on the scope of its current review and the relationship with the MCE work in developing a national framework for connection to electricity distribution networks is required.

Ergon Energy considers that the CPRS and expanded RET has the potential to impact distribution networks. First, if significant amounts of generation seek to connect to the distribution network, augmentation will be required to support those connections. This is particularly the case if generation seeks to connect to the network in areas where historically loads have not required a large network.

Second, a significant increase in small units of intermittent embedded generation, if not properly managed, may impact on power quality and safety. This means there is a need:

- for greater oversight of the volume, location and generation profile of these units; and

- to ensure that the energy market frameworks do not penalise distribution network service providers in meeting reliability requirements arising from lower reliability relating to electricity supply by intermittent renewable energy sources.

### **Wholesale Markets**

Ergon Energy welcomes the AEMC's conclusions around the suitability of the current wholesale electricity trading arrangements. In particular, its ability to deliver efficient, reliable and secure energy supplies in the context of the proposed climate change policies (CPRS and expanded RET).

### **Reliability**

Given the recent Reliability Panel review into the reliability settings of the National Electricity Market (NEM) did not take into account the impacts of climate change, the need to reassess these settings in order to ascertain the materiality of these policy changes is supported. However, any subsequent changes, permanent or temporary, must take into account the increase of the Market Price Limit (MPL), the need for regulatory certainty and that irrespective of the form of change (for example temporary mechanisms) a requirement for industry consultation.

As noted in our previous submission Ergon Energy does not support measures aimed at increasing the markets reliance on the long term use of NEMMCO's reserve trader mechanism/ Reliability Emergency Reserve Trader (RERT). These mechanisms have distortionary impacts on the market and place an undue burden on electricity retailers.

### **Retailing**

Ergon Energy welcomes the AEMC's conclusion that current approaches to retail regulation pose significant risks to electricity retailers due to their inflexibility to accommodate potentially large and rapid changes in retailer costs. Steps to increase the flexibility of these pricing arrangements, or at a minimum the introduction of a guaranteed pass-through of CPRS related costs, will assist retailers in their ability to offer competitive market contracts to customers. Furthermore, it will minimise the likelihood a Retailer of Last Resort (RoLR) event due to the financial failure of a retailer.

Whilst steps should be taken to address the increased possibility of a RoLR event post 2010, consideration should also be given to the MCE's work program in this area. In particular, the current timing of the MCE work program and subsequent legislative amendments suggest the changes required to mitigate the above risks will not be in place for the commencement of the CPRS or expanded RET. Consideration should therefore be given to the possibility of increasing the priority of the MCE project.

## **3 Response to questions**

### **Convergence of gas and electricity markets**

***Do you agree that the convergence of gas and electricity markets is not a significant issue in the eastern states and therefore should not be progressed further under this Review? If not, what are your reasons for reconsidering this position?***

Whilst the respective energy market arrangements are supportive of competitive, efficient and timely trading and investment, consideration should be given towards maximising these interactions. Delays in investment signals or inefficient market behaviour will impact the cost of energy for retailers and ultimately consumers.

Enhanced interactions could be effectively achieved through improved communication between the gas and electricity market operators. The most effective and efficient way of achieving active communication between the gas and electricity market operators is to establish minimum requirements in the operational and governance arrangements of the Australian Energy Market Operator (AEMO).

## **Generation capacity in the short-term**

***Do you agree that the ability for NEMMCO to manage actual or anticipated transitory shortfalls of capacity is a significant issue that should be progressed further under this Review?***

Recent policy announcements, such as the offer of transitional assistance in the White Paper for emission intensive coal fired generators, will assist in reducing the risk of significant short falls in generation. However, further action should be taken to consider whether policy or regulatory change is required to address current forecasts of tight reserve levels in the Victoria and South Australia regions.

Mechanisms such as the MPL have proved to be effective tools for signalling the need and location for new generation investment. Given the recent Reliability Panel review into the reliability settings of the NEM did not take into account the impact of climate change policies, the need to reassess these settings in order to ascertain the materiality of these policy changes is supported.

Consideration should also be given to whether NEMMCO has the ability to manage any significant reserve shortfalls. This investigation should look beyond the current market interventionist mechanisms such as the reserve trader mechanisms/ RERT mechanisms given these mechanisms have distortionary impacts on the market and place an undue burden on electricity retailers. These impacts are discussed further below.

Whilst it is expected there will be an increased willingness by generators to enter into energy contracts due to increased clarity around climate change policies, retailers may still be apprehensive. This is largely attributable to continued uncertainty around how the carbon price will be passed through to consumers, when retail prices are regulated (see section on Retailing).

***Are additional mechanisms required to complement the Reliability and Emergency Reserve Trader (RET) and NEMMCO's directions powers, and what characteristics should such mechanisms have?***

Current market interventionist mechanisms such as the reserve trader / RERT mechanism and system operator directions are by definition a back up plan. They also result in unhedgable costs for retailers which are solely borne by retailers operating under regulated retail prices. However, in markets where prices are unregulated, these costs would also be borne by consumers.

Given these mechanisms have distortionary impacts on the market and place an undue burden on electricity retailers Ergon Energy believes these current mechanisms and/or any attempt to broaden the scope of market interventionist models, should not be considered as long term solutions to supply shortfalls.

The market impact and ability of current mechanisms to deal with any significant shortfall of generation should be considered. Such an assessment will allow the associated risks to be identified (and quantified) and will facilitate the identification of options to address the perceived risks. However, throughout this process it is essential that the underlying cause of the shortfall is identified and fully understood. For example, any investigation should firstly establish whether



current policy settings have resulted in unexpected/perverse market outcomes such as encouraging participants to withhold load rather than offering it at times of short supply.

***Do you have any views on the detailed design and implementation of additional mechanisms?***

Any subsequent changes (permanent or temporary) to the mechanisms used to manage supply shortfalls should take into account:

- the Reliability Panel's recommendations, such as an increase in the MPL;
- the need for regulatory certainty, in particular the setting of minimum timeframes for implementing policy/regulatory changes and the triggers for any subsequent reviews into the effectiveness of current measures; and
- irrespective of the form of change (permanent or temporary), all proposed amendments should be subject to industry consultation.

## **Investing to meet reliability standards with increased use of renewables**

***Do you agree that the existing framework based on an energy-only market design with supporting financial contracting is capable of delivering efficient and timely new investment, including fast response capacity to manage fluctuations in outputs resulting from larger volumes of intermittent wind generation? If not, what are your reasons for reconsidering this position?***

***Do you agree that the processes supporting the ongoing maintenance of this framework in respect of review and periodic amendment to the market settings, including the maximum market price, are robust? If not, what are your reasons for reconsidering this position?***

Ergon Energy supports the AEMC's finding that the framework of the energy-only market is robust and provides appropriate signals for the timing, form and location of new investment.

However, Ergon Energy considers that a significant increase in intermittent embedded generation has the potential to impact on network reliability. This is particularly the case where the intermittent embedded generation has been installed on the basis of deferring network investment, but is unable to provide the same level of network reliability. Given this, it is important to ensure that the energy market frameworks do not penalise distribution network service providers in meeting reliability requirements arising from lower reliability relating to electricity supply by intermittent renewable energy sources.

## **System operation and intermittent generation**

***Do you agree that operation of the power system with increased intermittent generation is not a significant issue and therefore should not be progressed further under this Review? If not, what are your reasons for reconsidering this position?***

In the early development of electricity markets in Australia the division between the wholesale and retail markets closely matched the division between the transmission and distribution networks. Few scheduled generators (>30MW) were connected to the distribution networks and all wholesale market transactions were settled at the connection points between the transmission networks and the generators and at the connection points between the transmission and distribution networks. In the future with increasing distributed generation this division is likely to breakdown and distribution networks may need to provide more of the



“transmission” type of market facilities such as electronic communications between generators and the market operator and the two way transfer of power.

Further, in its previous submission, Ergon Energy highlighted the following challenges arising from a significant increase in intermittent generation:

- information on embedded generation: Currently generation units supplying less than 5MW at a network connection point are not required to be registered with NEMMCO. Consideration should be given to what information NEMMCO requires regarding embedded generation.
- generation flow: The above also means it is possible for significant amounts of generation to be connected to the interconnected grid without NEMMCO being aware of the volume, location or generation profile of these units. Ergon Energy notes that this has the potential to increase the risk of forecast inaccuracy and inefficient dispatch.

Ergon Energy considers that further consideration should be given to the impact of increased embedded generation on system operation and the potential for greater information requirement and co-ordination.

## Connecting new generators to energy networks

***Do you agree that the connection of new generators to energy networks is a significant issue that should be further progressed under this Review? If not, what are your reasons for reconsidering this position?***

***Would any of the models identified in this chapter ensure the more efficient delivery of network connection services? In particular, with relation to these models:***

- ***How should the risks of connection be most appropriately spread across new connection parties, network businesses and end use consumers?***
- ***How do the connection charges change for new connecting generation plant and what benefits may arise?***
- ***How do the costs for end use customers change and what benefits may arise?***
- ***Are there any other potential models that we should consider to mitigate this issue?***

The 1st Interim Report does not address in any detail the issues associated with the connection of embedded generation. Ergon Energy considers a statement from the AEMC is required on whether its Review extends to the connection framework for embedded generation and, if so, its relationship with the MCE work in developing a national framework for connection to electricity distribution networks.

Ergon Energy supports:

- the continuation of a bilateral negotiation approach to new connections;
- standard connection agreements for micro and mini embedded generation;
- individually negotiated connection agreements for small and large embedded generators;
- charges for connection of embedded generation to follow the same principle as those that apply to the connection of similar sized loads. That is embedded generation should

pay the cost of connection including anything that needs to be built to connect a new network user, and is dedicated to the particular connection point; and

- a cost-sharing scheme, where, in the event that a subsequent network user is connected and the amount of the initial customer's connection assets is reduced, and the initial network user may be entitled to a reduced price.

Ergon Energy also notes that the connection process established in clause 5.3 of the National Electricity Rules protects the confidentiality of information provided by connection applicants to Network Service Providers. Clause 5.3.8 provides that the data and information provided must not be disclosed to third parties except in certain circumstances. Ergon Energy, whilst not advocating its wholesale removal, considers that these provisions may limit the extent to which a distribution network service provider can assess and take into account future demand and potential connections in the area. The AEMC may wish to consider this issue in its future consideration of this issue.

## **Augmenting networks and managing congestion**

***Do you agree that the issue of network congestion and related costs requires further examination under this Review to determine its materiality? This includes considering whether the existing frameworks provide signals that are clear enough and strong enough in the new environment where congestion may be more material? If not, what are your reasons for reconsidering this position?***

Ergon Energy agrees that the issue of network congestion and related costs requires further examination under the Review. Ergon Energy again notes that a statement from the AEMC is required on whether its Review covers distribution network augmentation issues and, if so, its relationship with the MCE work in developing a national framework for connection to electricity distribution networks.

If significant amounts of generation seek to connect to the distribution network, augmentation will be required to support those connections. To date, most distribution networks have been developed to supply loads and existing capacity depends upon the size and location of these loads. In cases where generation seeks to connect to the network in areas where historically loads have not required a large network, for example remote areas, significant augmentation to the distribution network will be necessary.

From a retailer perspective network congestion is a key concern given the associated costs incurred through enhanced trading risks and increased electricity purchase costs. Furthermore, if congestion is not managed effectively it could impact liquidity in the contract market, thereby impacting market competition and ultimately the cost of energy for end users.

To ensure congestion is managed effectively, the AMEC should investigate the suitability of adopting a forward looking approach for identifying and dealing with enduring/material congestion. Such arrangements would allow increased levels of congestion - such as those being experienced in some areas of the NEM (e.g. South Australia) due to large concentration of wind farms – to be addressed in a timely and transparent manner, rather than waiting for the problem to manifest itself.

## Retailing

***Do you agree that the current inflexibility in the retail price regulatory arrangements is a significant issue that should be progressed further under this Review? If not, what are your reasons for reconsidering this position?***

Ergon Energy supports the AEMC's finding that current retail price regulation arrangements are not sufficiently flexible to cope with the potentially large and rapid changes in retailer costs.

As noted in Ergon Energy's previous submission, one of the key economic efficiencies of the CPRS is that energy users will be exposed to a transparent price for carbon. However, unless retail price caps are fully adjusted to reflect the cost of carbon, this transparent signal will not be passed on to customers.

With the introduction of the expanded RET and retention (at least in the short to medium term) of legacy jurisdictional renewable energy schemes there will be increased pressure placed on retail prices. If these increases are not captured in retail prices, the shortfall will be absorbed by retailers. This ultimately impacts a retailer's ability to offer competitive contracts to customers.

Ergon Energy welcomes the MCE's recent decision to amend the 2006 Australian Energy Market Agreement (AEMA) to specify that, where retail prices are regulated, energy cost increases associated with the CPRS shall be passed through to end-use customers. Albeit the details surrounding this commitment are yet to be articulated, this is a positive move in addressing some of the financial risks associated with the introduction of the CPRS and will assist in addressing the potential for increased retailer failure.

***Do you agree that the limitations with current ROLR arrangements are a significant issue that should be progressed further under this Review? If not, what are your reasons for reconsidering this position?***

Ergon Energy believes there are serious limitations with the current RoLR arrangements which should be progressed further under this Review. As noted in Ergon Energy's previous submission the introduction of the CPRS and expanded RET will present a significant challenge for retailers due to:

- higher pool prices as carbon is factored into dispatch bids. This will result in increased NEM prudential and other working capital arrangements;
- the potential risk of generators exiting the market due to financial collapse, may result in retailers losing hedge cover and facing unsustainable energy costs;
- delays in new generation investment may create opportunities for generators to maximise returns in the short term by reducing the availability of energy contracts and an increased reliance on energy sales at pool prices;
- increased potential for residential customers to experience financial hardship. While financial assistance will be provided through the introduction of household assistance measures it is yet to be demonstrated whether this assistance will be an adequate subsidy to offset the full price impacts of the CPRS; and

- due to the likelihood of many everyday goods and services increasing due to the CPRS there will be an increased requirement for debt management functions. As noticed over the last year, as the costs of living have increased, the need to prioritise everyday expenditures is increasing which in some case has resulted in the delayed payment of electricity bills.

These challenges on their own or in conjunction with other external factors may result in retailers defaulting on their obligations to NEMMCO, thereby triggering a RoLR event. Ergon Energy believes there is a material risk of RoLR events occurring in the post 2010 period.

Whilst steps should be taken to address the increased possibility of a RoLR event post 2010, consideration should also be given to the MCE's work program in this area. In particular, the current timing of the MCE work program and subsequent legislative amendments suggest the changes required to mitigate the above risks will not be in place for the commencement of the CPRS or expanded RET. Consideration should therefore be given to the possibility of increasing the priority of the MCE project.

***Are there any additional options that could supplement the processes currently under investigation to address these issues?***

No comment.

## **Financing new energy investment**

***Do you agree that financing, as an individual issue, should not be progressed further under this Review? If not, what are your reasons for reconsidering this position?***

No comment.