Energy Security Board

Draft Detailed Design of the National Energy Guarantee: Consultation Paper

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Helping businesses of all sizes maximise their potential

Introduction

The NSW Business Chamber (the Chamber) welcomes the opportunity to provide a submission to the draft detailed design of the National Energy Guarantee (NEG) Consultation Paper (the Consultation Paper).

The Chamber is one of Australia's largest business support groups, with a direct membership of more than 20,000 businesses and providing services to over 30,000 businesses each year. The Chamber works with businesses spanning all industry sectors including small, medium and large enterprises.

Energy affordability and need for a national approach

The decline in energy affordability is a serious concern for Australian business, particularly small business and manufacturing businesses who, in recent years, have struggled with substantial increases in energy prices.

The establishment of a NEG should present an opportunity to address energy affordability by encouraging additional investment in competitive supply and securing an affordable, reliable and environmentally responsible energy sector.

However, this opportunity is premised on two fundamental assumptions. Firstly, new generation can compete at a lower or comparable marginal cost to existing generation (without subsidises) and that the supply chain including retailers and networks are incentivised to pass cost savings and efficiencies to end-use consumers.

To operate effectively, the NEG will require states and territories to harmonise and/or abolish policies, subsidies and laws which run counter to the NEG or which otherwise inhibit energy supply. Policy settings and legislation, such as moratoria on domestic gas exploration along with measures that restrict the installation of wind turbines will reduce the capacity and effectiveness of the NEG. While we recognise the removal of state and territory policies is beyond the scope of the Consultation Paper it is important that the design of the NEG notes these issues.

Lowering energy prices

The NEG will require retailers to contract with generation (which may involve complementary storage or demand response) to achieve specified reliability and emissions targets. The Consultation Paper suggests the NEG provides ways to lower prices but does not outline in sufficient detail a mechanism or legislative safeguards to achieve this.

Generator revenues, and a retailer costs, are in part, determined by their net exposure to the volatility of the spot market and their ability to risk manage this volatility through contracts in hedge markets that fix the price of future electricity sales[1]. These markets are where energy supply is procured and generation investment decisions made based on demand. These arrangements continue under the NEG but with one fundamental difference.

The Chamber understands with discontinuation of the RET, the additional revenue stream many non-firm renewable energy generators (such as wind) were receiving will discontinue. This provides existing generators and prospective generators with an incentive to invest in complementary infrastructure (for example battery storage) to enable them to provide firm supply and compete with existing generators[2]. This will be achieved by generators entering into hedging contracts with retailers – a financial commitment of supply. More supply should mean more competition, which in turn should put downward pressure on price particularly if smaller retailers are able to compete with larger vertically integrated retailers. We discuss this further below.

An important measure of success of the NEG will be downward price pressure on the supply of electricity and natural gas. Given the above, the Chamber believes the main way this will be achieved is if the NEG promotes competition and transparency in retail markets.

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[1] Australian Energy Market Operator (AEMO) fact sheet: How the spot market works

[2] Cost savings (and investment return) will also be premised on where the new generation is located and whether new transmission lines will need to be built to transport the energy it generates. Transmission networks are regulated monopolies. The issue of who pays for the transmission augmentation, the generator or the network, has not been established and is currently being considered by the Australian Energy Market Commission (AEMC). In the case of the former, generation procured through retailers will be passed on to its customers, in the case of the latter the network may recover its costs though all consumers. This represents a subsidy and will need to be thought through carefully – as a general principal, the Chamber prefers causer pays.

This is because the Chamber understands that once retailers procure generation to meet their broad emissions and reliability targets, they remain free to choose the margins they pass on to customers. Furthermore, customers will continue to have little visibility as to how much contracting in the spot and hedge markets are contributing to end use price.
If the cost of capital for generation falls during the NEG (which the NEG assumes), it is unclear how these savings would be passed on to consumers.

A retailer's gross margin is the difference between its revenues and its cost of goods or services sold. Periodic data on gross margins informs any change in the relationship between revenues and these costs over time. However, it does not inform whether the return on the cost of capital is commensurate with the risk it undertakes on behalf of its customers from being exposed to the price volatility of the wholesale electricity spot market in the retail prices they pay.

Furthermore, all electricity is traded in the National Energy Market (NEM) but the revenue a retailer receives is determined by its contracted position with a generator. Retailers can make additional profits through arbitrage, essentially betting on whether electricity prices will go up or down.

Both the AEMC retail energy competition review[3] (AEMC review) and the ACCC's retail electricity pricing inquiry preliminary report[4] (ACCC report) have confirmed there is insufficient competition in the generation and retail markets which is causing price rises. Further, in a recent appearance before a NSW parliamentary inquiry[5] energy retailers struggled to explain retailer costs and retail margins taking these questions on notice, citing that it was too complex to explain. This level of complexity does not inspire confidence for transparency in the lead up to the NEG.

The Chamber proposes a simple but effective inclusion in the detailed design of the NEG which would increase transparency with a flow on effect on the level of competition in retail and wholesale electricity markets.

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[3] AEMC, 2018 Retail Energy Competition Review, Final Report, 15 June 2018, Sydney
[4] ACCC retail electricity pricing inquiry preliminary report
[5] https://www.parliament.nsw.gov.au/lcdocs/transcripts/296/Hearing%20Schedule%20-%208%20May%202018(3).pdf

Recommendation

The Australian Energy Regulator (AER) will be the agency responsible for monitoring and enforcing compliance of the NEG. The AER currently only regulates the network (poles and wires) revenues and has limited visibility over retailer and generation profits and margins, and whether retailers are passing on network price signals. The Chamber submits consideration should be given to expanding the role and functions of the AER. Accordingly, the Chamber recommends an obligation for retailers to provide the AER with annual financial statements of its retail and generation activities.

These statements would increase transparency by segmenting revenues, costs and profits across their retail and generation/procurement activities (and could be reported across tariff types and generation source). This would provide some transparency regarding the rate of return on investments and how network price signals are passed through.

A similar approach has been adopted in the United Kingdom to increase transparency and improve retail competition outcomes. The statements would inform the AER and the Energy Security Board as to whether the objectives of the NEG are met at the lowest overall cost through annual comparison of these statements and visibility over the entire energy supply chain. The AER can decide on whether the statements (or part thereof) should be disclosed publicly.

As noted by the AEMC report[6], there has been an increasing trend of large retailers in the NEM vertically integrating by acquiring generation assets. A retailer that is vertically integrated is physically hedged, meaning it has direct access to generation to cover some of its demand. Therefore, it does not need to purchase as much generation from another party, or enter into a financial hedge contract for supply. However, this reduces contracting and may affect the level of liquidity in the wholesale contracts market; reduced liquidity potentially impacts on how stand-alone retailers compete and manage their exposure to wholesale spot market risk.

[6] AEMC, 2018 Retail Energy Competition Review, Final Report, 15 June 2018, Sydney, p 21

The Chamber submits that if alternative forms of generation become increasingly dispatch-able and affordable, smaller retailers may invest in their own generation which would reduce their exposure to the wholesale market. Moreover, excess generation supply could be contracted to other retailers (which would assist with liquidity). To support retail market (and wholesale market) competition for smaller retailers (and consistent with the exemption from the emissions requirement), retailers servicing less than 50,000 MWh of load should be exempt from reporting.

For more information contact:

Robert Millar

NSW Business Chamber

Tel: 02 9458 7324

Email: robert.millar@nswbc.com.au